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Shareholder Activism

Benefits and Drawbacks

A) The thesis

I) Motivation

According to the well-known U.S.-American financial investor Wyser-Pratte, who has been active since the 1970s, there are not only good active investors. There are also bad ones who trample the practices of local cultures, fire people, and enrich themselves at the expense of others, as some U.S.-American Funds have done. In Germany, the “Locust Debate,” a discussion about the benefits and drawbacks related to active investors, began in 2005. Franz Müntefering, at that time head of the Social Democratic Party in Germany, used active investors, whose presence in Germany was rather new, as scapegoats to win the 2005 election.²

In both Germany and the United States, the debate about the benefits and drawbacks of active shareholders is closely related to the question of the adequacy of existing provisions in restricting destructive activism, the necessity of additional statutory provisions to restrict active shareholders in negatively affecting targeted corporations, or the need to lift current legal limitations that apply to (active) shareholders. Recent data on the long-term effects of shareholder activism applied to U.S. firms relating closely to short-termism as the sharpest charge active shareholders in both countries have been confronted with has fueled the debate again.

II) Aim, scope, and method

1) Aim

This study seeks to answer the following question: to what extent do the benefits and drawbacks of shareholder activism require the amendment of the current law? This question includes determining the necessary legal means and limitations in maximizing the positive function of shareholder activism in improving corporate governance. Such means and limitations could reduce agency issues and costs resulting from the separation of ownership and control while minimizing the potential for shareholder activism to be abused by opportunistic shareholders. This thesis will examine the current opportunities for shareholder activism and determine whether these should be maintained, legally restricted or increased in the light of their potential for abuse by those with vested interests that drastically deviate from the interest of the corporation. The aim regarding

2 Martin Dowideit/Anette Dowideit, „Je mehr ein Fisch zappelt, desto größer ist er“, DIE WELT, Dec. 20, 2005, available at http://www.welt.de/print-welt/article185389/Je_mehr_ein_Fisch_zappelt_desto_groesser_ist_er.html.

the latter two scenarios is to propose legal amendments necessary to support the function of shareholder activism while at the same time preventing abuse that could harm the corporation and its investors.

2) Scope

This work will compare the U.S.-American corporate and securities law and the German corporate and capital market law relevant to determining the opportunities and restrictions for shareholders to actively influence publicly listed corporations. Because of the multiplicity of corporate laws at the state level in the United States, this work will concentrate on the corporate law of the State of Delaware, which is in practice the most significant among the different states in terms of laws governing corporations.³ Despite Delaware's small size and population, a disproportionate number of corporations have incorporated there, including half of the publicly traded corporations and the majority of the large publicly traded corporations.⁴ Delaware's popularity stems from its extraordinary flexibility regarding the arrangement of the articles of incorporation of corporations as well as the state legislators' restraint in passing regulations.⁵

After a general introduction on shareholder activism and the underlying theories and relevant practical differences in the United States and Germany, this work will focus on three strategies repeatedly applied by active shareholders. The analysis will consider the means of active shareholders as well as the limitations they confront. Furthermore, it will take into account the controversies each strategy triggers.

3) Method

This work is a comparative analysis of the current opportunities and restrictions on active investors in public corporations imposed by American corporate and securities laws and the German corporate and capital-market regime that are pertinent to increasing control of corporate management as well as to the concerns confronting active shareholders.⁶

This study makes use of a functional approach⁷ that considers economic models of the firm, particularly the modeled assumptions and analytical methods of the New Insti-

3 Becker, *Verwaltungskontrolle durch Gesellschafterrechte*, 1997, 105 et seq.; Greenfield, 67 LAW & CONTEMP. PROBS. 135, 135–37 (2004).

4 Bebchuk & Hamdani, 112 YALE L.J. 553, 554 n.3 (2002): “Delaware is the state of incorporation for 51 percent of U.S. public companies and for 63 percent of Fortune 500 companies.”; Greenfield, *supra* note 4, at 135.

5 Leyens, *RabelZ* 67, 57 (69 et seq.).

6 Dannemann, *Comparative Law: Study of Similarities or Differences?* in Reimann/Zimmermann, THE OXFORD HANDBOOK OF COMPARATIVE LAW 383, 399 (2006).

7 Michaels, *The Functional Method of Comparative Law* in Reimann/Zimmermann, THE OXFORD HANDBOOK OF COMPARATIVE LAW 339, 340 et seq (2006).

tutional Economics⁸ regarding public corporations. These methods include complementary used-agency⁹ and transaction-cost¹⁰ theories of the firm¹¹ as well as of nonlegal institutions. Transaction costs may result from trading relations between contractual partners and may be reduced in an organization like a firm. Agency costs, on the other hand, evolve in hierarchies based on incomplete information, permitting opportunism and different risk tolerances, among others. The aim of these approaches is to maximize the overall economic benefit of the involved parties by reducing the use of resources, including transaction or agency costs.

8 Fleischer, ZGR 2001, 1 (3 et seq.).

9 Jensen & Meckling, 3 J. FIN. ECON. 305 (1976).

10 Coase, 4 ECONOMICA 386, 390 et seq. (1937): according to whom the market may be led by an invisible hand, so Adam Smith, but there is a cost of using this price mechanism; Williamson, Die ökonomischen Institutionen des Kapitalismus: Unternehmen, Märkte, Kooperationen, 1990, 17 et seq.

11 POSNER, ECONOMIC ANALYSIS OF LAW 419 et seq. (420), 440 et seq. (2007); Ruffner, Die ökonomischen Grundlagen eines Rechts der Publikumsgesellschaft, 2000, 131; Schäfer/Ott, Lehrbuch der ökonomischen Analyse des Zivilrechts, 2005, 645.

B) Introduction to shareholder activism

I) What is shareholder activism?

1) Definition of shareholder activism

Shareholders dissatisfied with the management of a corporation or corporate performance may decide for the “exit” and adopt the “Wall-street-rule” by selling their shares. They may also continue to hold their shares without doing anything, better known as “loyalty.”¹² Shareholders who aim to express their dissatisfaction employ a wide range of means lying between the sale of shares and the initiation of takeovers or LBOs.¹³ In 1972, *Hirschmann* defined this “voice” option as any attempt to change rather than to escape from an objectionable state of affairs through individual or collective positions to the management directly in charge, appeals to a higher authority with the intention of forcing a change in management, or various types of actions and protests, including those meant to mobilize public opinion.¹⁴ Its function is to alert a firm or organization to its failings while giving it some time and the choice to respond to the pressures that have been brought to bear on it,¹⁵ depending on the costs of alternatives.¹⁶ Nowadays, shareholder activism refers to the interest of shareholders in shaping the direction of their company through their participation in the normal processes that shape the company, such as voting through proxies during a shareholder meeting. At the other extreme lies the popular hedge fund practice of accumulating shareholder minority positions in public companies large enough to move the companies single-handedly in one direction or the other or in whatever form the activist practice may take. As a consequence, it is clear that the term refers to attempts by different types of shareholders to use whatever power they have as owners to influence the company’s behavior regarding a wide range of topics from corporate governance issues to pure management decisions.¹⁷ Despite this broad interpretation, active shareholders need to be distinguished from the German

12 Gillan & Starks, *The Evolution of Shareholder Activism in the United States* 6, www.ssrn.com/abstract=959670 (2007); but see Ruffner, *Die ökonomischen Grundlagen eines Rechts der Publikumsgeellschaft*, 2000, 441 et seq.: distinguishes Exit, Passivity and Control.

13 Gillan & Starks, *The Evolution of Shareholder Activism in the United States*, 5 et seq., www.ssrn.com/abstract=959670 (2007); Gillan & Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence* 4, www.ssrn.com/abstract=663523 (1998).

14 HIRSCHMANN, *EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* 30 (1970).

15 *Id.* at 33.

16 *Id.* at 136.

17 Bassen, *Einflußnahme institutioneller Investoren auf Corporate Governance und Unternehmensführung*, 2001, 4 et seq., 7 et seq.; Bertaccini, 31 *CARDOZO L. REV.* 267, 267 (2009); Gillan & Starks, *The Evolution of Shareholder Activism in the United States* 5 et seq. www.ssrn.com/

phenomenon of professional opponents, whose goal is obstruction when they file legal suits against corporations to extract personal benefits. In contrast, active shareholders generally aim to exercise constructive control over the corporate administration^{18 19}. This introductory section on shareholder activism will therefore consider the varieties of shareholder activism regarding the actors and the strategies and means they apply to pursue them.

2) Motivation to become active²⁰

There may be good reasons for shareholders of large public corporations to remain passive instead of exerting their rights. These reasons include shareholder confidence in managerial expertise, limited returns from potential corporate value increase for individual shareholders with minimal stakes, and free-riding issues^{21 22}. Additional reasons are the dispersed ownership amongst many shareholders—requiring complicated and costly efforts to realize joint decisions (collective-action issue²³)²⁴—the quicker and less costly “exit” solution, the limited liability of shareholders,²⁵ and legal obstacles preventing them from using formal accountability mechanisms^{26, 27}.

Nevertheless, increasing numbers of shareholders decide to become active. “The main motive for active participation of institutional investors in the monitoring of cor-

abstract=959670 (2007); Kahan & Rock, 155 U. Pa. L. Rev. 1021 (2007); Schneider, AG 2006, 577 (577).

18 For practical reasons, this work will refer, where possible, to the “administration” when referring to supervisory board and/or management board and/or board of directors and/or executive officers.

19 Dreher, ZHR 157 (1993), 151 (167); Götze, in: Von Rosen, Die Hauptversammlung vor neuen Herausforderungen, DAI studies issue 41, 2008, 119 (120); Thaeter/Guski, AG 2007, 301 (301 n.3); Werner, Zur Treupflicht des Kleinaktionärs, in: Bierich et al., FS Semler, 1993, 419 (420 et seq.).

20 Arnold, ZCG 2008, 221 (225); Gillan & Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence* 13, www.ssrn.com/abstract=663523 (1998); Winkler, Die Verantwortung institutioneller Anleger als Aktionäre in Publikumsgesellschaften in Deutschland und den USA, 2008, 90 et seq.

21 CLARK, CORPORATE LAW 94 (1986): “[F]reerider problem—the temptation faced by each individual member of a large group, like the shareholders of a public corporation, to fail to make the effort needed to contribute to a group action, because he hopes that the other will do the work and he will benefit anyway.”

22 Garrido & Rojo, *Institutional Investors and Corporate Governance: Solution or Problem in HOPT & WYMEERSCH, CAPITAL MARKET AND COMPANY LAW* 427, 428 (2003).

23 EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 66 et seq. (1991); Ruffner, Die ökonomischen Grundzüge eines Rechts der Publikumsgesellschaft, 2000, 174 et seq., for more details *see note 306*.

24 Black, 89 MICH. L. REV. 520, 525 (1990): noting that shareholder passivity is less a problem of collective action than of legal barriers.

25 Fleischer, ZGR 2001, 1 (17).

26 Black, 89 MICH. L. REV. 520, 530–66 (1990): summarizing legal obstacles; Briggs, 32 J. CORP. L. 681, 701 (2007).

27 CHEFFINS, COMPANY LAW 62 (1997).

porations has been the potential to *enhance the value of their personal investments*.²⁸ The rationale for shareholder activism arises from the need to *resolve agency conflicts* inherent in a public corporation. Shareholders, as the (economic) owners of the corporation, delegate the decision-making to managers. The board of directors, bound by fiduciary duties towards the shareholders, is supposed to control management. This structure is intended to avoid possible agency problems such as managerial opportunism, in which managers make decisions in their own interest, rather than seeking to benefit shareholders by maximizing shareholder value. Using their delegated responsibility of hiring, firing, compensating, and monitoring the managers, the board of directors can ensure that managers act for the benefit of shareholders.²⁹ A need for shareholder activism arises when the board is not exercising its control task,³⁰ and, therefore, the organizational structure cannot fulfill its task in reducing agency issues resulting from the opportunistic decisions and actions of the managers. Besides the stock market and the market for corporate control, shareholder activism is a means of a *non-control related monitoring* by active investors that can reduce or eliminate these agency issues.³¹

Shareholders, such as the decreasing number of blockholders in the case of German corporations and institutional shareholders in U.S. and German corporations, are a less diversified group. Due to the size of their shareholdings they have the opportunity to overcome *rational apathy* problems based on *free-rider* issues. The larger sizes of their stakes may allow them to be compensated for their efforts to become active. Furthermore, their large total investments reduce *collective action* problems, while access to greater amounts of capital allows them to circumvent legal obstacles. The size of their stakes provides them with *stronger incentives* to become active, since it is usually difficult to choose the “exit” option by selling their stake without giving a significant discount.³²

- 28 Gillan & Starks, *The Evolution of Shareholder Activism in the United States* 34, www.ssrn.com/abstract=959670 (2007); Götze, in: Von Rosen, *Die Hauptversammlung vor neuen Herausforderungen*, DAI studies issue 41, 2008, 119 (123).
- 29 Jensen & Meckling, 5 J. FIN. ECON. 305 (1976), available at www.ssrn.com/abstract=94043, 5: referring to an agency relationship as a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent, but despite monitoring and bonding expenditures, the decisions of the agent will still diverge from the decisions that would maximize the welfare of the principal; Gillan & Starks, *The Evolution of Shareholder Activism in the United States* 13, www.ssrn.com/abstract=959670 (2007).
- 30 Gillan & Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence* 13 www.ssrn.com/abstract=663523 (1998).
- 31 Fama & Jensen, 26 J. L. & ECON. 301, 313 (1983), available at www.ssrn.com/abstract=94034: referring to the stock market, the market for takeovers, expert boards as methods to control the agency problems of common stock; Arnold, ZCG 2008, 221 (225).
- 32 CHEFFINS, COMPANY LAW 63 (1997).

3) History of shareholder activism

Shareholder activism has a longer history in the United States than in Germany. In the United States, shareholder activism has existed since the first half of the past century. After the adoption of the predecessor to Rule 14a-8 of the Securities Exchange Act of 1934,³³ individual shareholders began to submit proposals that aimed to improve corporate governance as well as corporate performance.³⁴ Several decades later, shareholders increasingly used these measures to focus not only on corporate governance, but also on social issues.³⁵ Beginning in the mid-eighties, several groups of active shareholders emerged using shareholder proposals that generally aimed to raise awareness of the directors' accountability to shareholders.³⁶ During the mid-eighties and onward, the steadily growing amount of investments held by institutional investors³⁷ led to their growing stakes in and impact on corporations and resulted in their active involvement, marked by the formation of the Council of Institutional Investors ("CII"). The CII started as a lobbying group for shareholder rights. Later it began to focus on advancing the perspectives of institutional investors. The CII initially focused on proxy proposals, but by the early 1990s it increasingly made use of its access to the administrations and the media. With the decline of the takeover market and the repeated amendment of securities rules beginning in the 1990s, communication among shareholders on matters of voting as well as with the administration was improved.³⁸ The increasing

33 The Securities Exchange Act of 1934 (hereinafter „SEA“) refers to §§ 78a and following of title 15 of the United States Code (15 U.S.C. §§ 78a et seq.).

34 Gillan & Starks, *The Evolution of Shareholder Activism in the United States* 34, www.ssrn.com/abstract=959670 (2007).

35 Gillan & Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence* 6 et seq., www.ssrn.com/abstract=663523 (1998).

36 Gillan & Starks, *The Evolution of Shareholder Activism in the United States* 7 et seq., www.ssrn.com/abstract=959670 (2007).

37 ABA/Section of Business Law, 65 BUS. LAW. 107, 135 (2009): estimating that in 2006 private stock ownership had fallen to 33 percent of U.S. equity, in 2007 76,9 percent of the largest 1000 companies were already owned by institutional investors; Kahan & Rock, *Embattled CEOs* 11, <http://ssrn.com/abstract=1281516> (2008).

38 Anabtawi & Stout, 60 STAN. L. REV. 1255, 1279 (2008); David Ben-Ur/Corbin Capital Partners, *Shareholder Activism* 2, <http://www.pionline.com/assets/docs/CO19344522.PDF> (2007): Besides comparably strong liquidity of corporations in the middle of the first decade of the new millennium, the corporate scandals of the early 2000's spurred substantial regulatory reform, like the Regulation Fair Disclosure and Sarbanes-Oxley Act, which enhanced the powers of shareholders at the expense of management teams and corporate boards, and more general the malfeasance at major corporations like WorldCom, Enron, and Tyco reduced the reputations of executives and boards and increased the public acceptance of activist programs. More importantly, traditional investors have come out strongly in favor of improved governance practices and their presence has substantially strengthened the hand of activist funds, efficiency enhancing technologies improving the activist tool-kit, and finally slimmer profit opportunities, resulting in many managers gravitating towards activist approaches.; Black, *Shareholder Activism and Corporate Governance in the United States* 1, www.ssrn.com/abstract=45100 (1997): pointing out the modest success of the 1992 amendments of the proxy rules in reducing barriers to coalition building amongst institutions; Briggs, 32 J. CORP. L. 681, 686 (2007); Briggs, 50 BUS. LAW. 99, 99, 147 (1994): Even though only intended to improve communication amongst passive shareholders, active investors have also reaped many of the benefits. But