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Full of Hot Air? Evaluating the Airgas Court's Reservations About Shareholders' Short-Term and Long-Term Interests in Takeovers

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ABSTRACT

This Note explores the incentives and preferences of shareholders in takeovers. This analysis is conducted in the context of the Delaware Chancery Court's February 2011 decision in *Air Products & Chemicals v. Airgas*. In that case, the court's decision largely turned on whether certain short-term and long-term shareholders have different preferences and incentives in takeovers. This Note adopts a similar focus but frames the question in terms of whether Hedge Funds, shareholders perceived as short-term motivated, and Institutional Investors, shareholders perceived as long-term motivated, evince different preferences and incentives in takeovers. This Note's analysis relies on both academic inquiries into the shareholders' investment strategies and empirical data about the shareholders' actual investment choices. This Note also compares and contrasts its findings with existing academic takeover analysis. Overall, this Note finds limited evidence of similarities between these shareholders' incentives and preferences in the takeover context.

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INTRODUCTION

The Delaware Chancery Court's decision in *Air Products & Chemicals, Inc. v. Airgas Inc.*[1] presents a distinct turn in poison pill doctrine. One important question before the *Airgas* court was how long a target company could maintain a poison pill as a defense against an unsolicited merger attempt.[2] Previous Delaware state court jurisprudence established that the threat of uninformed shareholders tendering into an inadequate bid was a legitimate threat justifying the maintenance of a pill.[3] *Airgas* presents a distinct turn from this line of

1. 16 A.3d 48 (Del. Ch. 2011).
2. *Id.* at 113.
3. *See, e.g.*, Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1384–85 (Del. 1995).

cases. The court held that the threat of a large number of merger arbitrageurs tendering into an inadequate bid, thereby destroying shareholder wealth, justifies the maintenance of a pill.[4] Through this decision, the *Airgas* court drew a distinction between short-term and long-term shareholder interests in takeovers, and relied on these shareholders' disparate economic incentives as the crucial factor permitting maintenance of a pill.

This Note reviews the *Airgas* court's analysis and considers whether Hedge Funds and Institutional Investors[5] have sufficiently dissimilar preferences and incentives in takeovers to justify different treatment for *Unocal* purposes.[6] Part I describes the *Airgas* decision. Part II examines Hedge Funds' general investment strategies and how they affect takeovers. Next, Part III considers Institutional Investors' general investment strategies and how they affect takeovers. Part IV compares and contrasts the broader economic interests of Hedge Funds and Institutions and finds limited evidence of similarity. Part V discusses the impact of these findings on previous analysis by legal scholars and courts about what takeovers should be allowed. Finally, this Note concludes by discussing other considerations affecting takeover jurisprudence.

I. *AIRGAS*, ARBITRAGEURS, AND *UNOCAL*

Part I introduces the *Unocal* standard governing enhanced judicial scrutiny for defensive measures in takeovers. Next, it examines the *Airgas* court's application of that standard. Finally, this part explores the *Airgas* court's reservations about its conclusion.

A. THE *UNOCAL* STANDARD

As a defensive measure against a hostile bid, the maintenance of a poison pill is evaluated under the familiar *Unocal* standard.[7] To satisfy enhanced *Unocal* scrutiny of defensive measures, a target board must

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4. *Airgas*, 16 A.3d at 111–13.

5. Throughout this Note, the term Institutional Investors will be used interchangeably with Institutions.

6. Parts II, III, and IV of this Note explore in depth how Hedge Funds are different from Institutional Investors, and vice versa, on the basis of the typical investment strategies of each type of investor and the economic preferences and incentives that result from such strategies.

7. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

show that: (1) "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and (2) any response to that threat "[was] reasonable in relation."[8] "Directors satisfy the first part of the *Unocal* test by demonstrating good faith and reasonable investigation" in their determination that the bid constituted a threat.[9] In addition to showing the reasonableness of their process, the board must also articulate a legitimate threat to corporate policy and effectiveness.[10] Under the second part of the *Unocal* test, courts evaluate whether the board's response to the threat was disproportionate, meaning "draconian, by being either preclusive or coercive."[11] If not, the court then determines whether the board's actions fell "within a range of reasonable responses to the threat" posed.[12]

B. *AIRGAS*

In *Airgas*, the Airgas board faced a series of unsolicited all-cash, all-shares merger bids from Air Products and refused to redeem its poison pill for over a year.[13] From the time Air Products first approached Airgas until the day this case was decided, Airgas shares ranged from \$41.64 to \$71.28.[14] Even though the tender offers reached as high as \$70 per share, Airgas' majority-independent director board believed that the offers were inadequate.[15] The board believed that the company was worth \$78 per share, relying on three reports by independent financial advisors.[16]

Applying the first prong of the *Unocal* test, the *Airgas* court identified the articulated threat as "inadequate price" and "the fact that a

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8. *Id.* at 955.
9. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1152 (Del. 1990).
10. Chesapeake Corp. v. Shore, 771 A.2d 293, 301 n.8 (Del. Ch. 2000).
11. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995). A defensive measure is coercive if it is "aimed at 'cramming down' on its shareholders a management-sponsored alternative." *Id.* at 1387 (citing Paramount Commc'n, Inc. v. Time, 571 A.2d 1140, 1154–55(Del. 1990)). A defensive measure is preclusive if it "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'" Carmody v. Toll Brothers, Inc., 723 A.2d 1180, 1195 (Del. Ch. 1998) (quoting *Unitrin*, 651 A.2d at 1389).
12. *Unitrin*, 651 A.2d at 1367.
13. Air Prods. & Chems., Inc. v. Airgas, Inc.,16 A.3d 48, 55–56 (Del. Ch. 2011).
14. *Id.* at 61.
15. *Id.* at 108.
16. *Id.* at 111.

majority of Airgas's stock [was] held by merger arbitrageurs[17] who might be willing to tender into such an inadequate offer."[18] Relying on the long-standing principle that a board may reasonably rely on independent financial advisors, the court first determined that the Airgas board had a good faith, reasonable belief that the final offer was inadequate.[19] In light of "sufficient evidence that a majority of stockholders might be willing to tender their shares regardless of whether the price is adequate or not,"[20] the court determined that the alleged threat was legitimate and that the first prong of the *Unocal* test was satisfied.[21] The court found that the second prong of the *Unocal* test was satisfied as well. The board's actions were not "draconian" because Air Products could run another proxy contest to replace the Airgas board.[22] The board's response was within a range of reasonableness because it "[did] not *forever* preclude Air Products" from running a proxy contest[23] and permitted the company to continue being run successfully according to the status quo.[24]

In evaluating the board's perceived threat that shareholders may tender into an inadequate offer, the *Airgas* court (somewhat inconsistently) used the term "merger arbitrageur" to classify investors perceived to have short-term economic incentives.[25] At the time litigation commenced, this type of shareholder constituted half of the company's shareholder base.[26] The court's classification yields two key characteristics of short-term-driven investors. First, these investors' economic incentives[27] are driven by their use of merger arbitrage and event-driven investment strategies.[28] Second, Hedge Funds represent a substantial portion of the investors utilizing these strategies.[29]

17. *See infra* notes 25–30 and accompanying text.
18. *Id.* at 105.
19. *See id.* at 110.
20. *Id.* at 111.
21. *Id.* at 111–12.
22. *Id. at* 120–22.
23. *Id.* at 124.
24. *Id.* at 124–25.
25. *See id.* at 109–112.
26. *Id.* at 109 ("[A] large percentage (almost half) of Airgas's stockholders are merger arbitrageurs.").
27. *See id.* at 118 (noting Airgas's expert witness' chart identifying 46% of outstanding shares as held by "arbitrageurs and event-driven investors").
28. *See generally infra* Part II.C. (explaining these strategies).
29. *Airgas*, 16 A.3d at 109 n. 413.

The *Airgas* court went on to explain the rationale for classifying shareholders based on their economic incentives. Since many of these shareholders purchased Airgas stock "at [the bid's commencement or, at least at] a time when the stock was trading much lower than it is today . . . they stand to make a significant return on their investment even if the [tender] offer grossly undervalues Airgas."[30] Relying on the evidence in the record, particularly each party's expert witnesses on shareholder voting, the court noted that there was adequate evidence to find that "a large number—if not all—of the arbitrageurs . . . would be happy to tender their shares, [if profitable], regardless of the potential long-term value of the company."[31] Thus, the court concluded, "the risk" of a large number of short-term-driven shareholders tendering into an inadequate offer at the expense of long-term shareholders' interests constitutes a legitimate threat for *Unocal* purposes.[32]

C. THE CONTROVERSY

Writing the opinion, Chancellor William B. Chandler expressed frustration with the result but considered the court to be constrained by Delaware precedent.[33] Reviewing the development of *Unocal* jurisprudence, Chandler traced the idea that shareholders might tender into an inadequate offer back to concerns that shareholders were not sufficiently informed by the company's board.[34] But, he continued, "[o]nce the stockholders have access to [adequate] information, the potential for stockholder 'confusion' seems substantially lessened."[35]

30. *Airgas*, 16 A.3d at 109.

31. *Id.* at 111.

32. *Id.* at 111–12 ("This is a clear 'risk' under the teachings of *TW Services* and *Paramount* because it would essentially thrust Airgas into *Revlon* mode.")

33. *See generally id.* at 57–58 (briefly describing reservations about the decision).

34. *See generally id.* at 93–94 (reviewing the development of *Unocal* jurisprudence).

35. *Id.* at 100; *id.* at 57 ("Airgas's stockholder base is sophisticated and well-informed, and . . . essentially all the information they would need to make an informed decision is available to them. In short, there seems to be no threat here—the stockholders know what they need to know (about both the offer and the Airgas board's opinion of the offer) to make an informed decision."); *id.* at 100 ("If the stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation has been afforded them?") (quoting Chesapeake v. Shore, 771 A.2d 293, 328 (Del. Ch. 2000)).

Chandler continued on to note that Airgas' shareholders were sophisticated, well-informed, and had access to "essentially all the information" they would need to make an informed decision.[36] Thus, in his view, but for *Unocal* and its progeny, Airgas' stockholders would be permitted to vote.[37] Indeed, "directors of a corporation still owe fiduciary duties to *all stockholders*—this undoubtedly includes short-term as well as long-term holders."[38]

Binding Delaware precedent, however, focuses judicial scrutiny of a company board's actions on whether a company is affirmatively selling itself—meaning *Revlon* applies[39]—or maintaining the status quo—meaning *Unocal* applies—instead of considering whether shareholders are adequately informed.[40] Here, merger negotiations had reached an apparent "end stage" and the Airgas board continued to resist Air Products' merger overtures.[41] Ultimately, Delaware precedent provides that "a board cannot be forced into *Revlon* mode any time a hostile bidder makes a tender offer that is at a premium."[42] Thus, Chandler reluctantly concluded that *Unocal* was satisfied in this case and the pill could be maintained.[43]

II. WHAT ARE THE PREFERENCES AND INCENTIVES OF HEDGE FUNDS?

Part II will provide a basis to explain Hedge Funds' incentives and preferences. Section A will provide a background of Hedge Funds. Section B will develop the common investment strategies used by Hedge Funds. Section C will identify merger arbitrage and event-driven activism as the two strategies most applicable to takeovers and describe how they work. This section will also identify common conflicts of interest posed by Hedge Funds, particularly in relation to derivative use.

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36. *Id.* at 100–01.

37. *Id.* at 101.

38. *Id.* at 129.

39. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173 (Del. 1986), the Delaware Supreme Court held that, when a Delaware corporation puts itself up for sale, its directors have an affirmative duty to seek the best price for its shareholders.

40. *Airgas,* 16 A.3d at 103 ("Thus, it seemed . . . that so long as a corporation is not for sale, it is not in *Revlon* mode and is free to pursue its long run goals. In essence, . . . a well-informed board acting in good faith in response to a reasonably perceived threat may, in fact, be able to 'just say no' to a hostile tender offer.").

41. *Id.* at 100–01.

42. *Id.* at 129.

43. *Id.*

A. WHAT IS A HEDGE FUND?

Hedge Funds "are actively managed investments that pool investors' capital in order to acquire, own, and trade one or more of securities, commodities, and financial products."[44] According to Hedge Fund Research Inc., global assets under management reached $2.19 trillion as of the end of the third quarter of 2012.[45] In comparison to other investment vehicles, Hedge Funds face few regulatory restrictions.[46] Investments are premised on managers' skill in generating a risk-adjusted return, or "alpha."[47] Managers are typically compensated in two forms: management fees equal to 1 to 2% of assets under management[48] and performance fees equaling 20% of investment returns that exceed a certain "hurdle" rate.[49] When losses deplete investors' initial capital contributions, managers are generally precluded from receiving performance-based compensation until that capital is restored and the specified rate has been exceeded.[50] Investors are usually not contractually permitted to sell or redeem their shares for a specified amount of time called a "lock-up" period[51] without incurring redemption fees.[52]

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44. Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 324 (2007).

45. *Hedge Fund Assets Surge to Record in Third Quarter*, HEDGE FUND RESEARCH, INC., 1 (2012), https://www.hedgefundresearch.com/pdf/pr_20121018.pdf.

46. *See generally* Lydie N.C. Pierre-Louis, *Hedge Fund Fraud and the Public Good*, 15 FORDHAM J. CORP. & FIN. L. 21, 46–55 (2009) (discussing the limited scope of hedge fund regulation).

47. *See id.*, at 43.

48. This is calculated based on the Net Asset Value and equals the Fund's Assets less Liabilities, or Equity. *See* STUART A. MCCRARY, HOW TO CREATE & MANAGE A HEDGE FUND 14 (John Wiley & Sons, Inc.) (2008).

49. *Id.* at 14–15. For example, a typical Hedge Fund subscription agreement for $1 million might entitle a Hedge Fund manager to 1.5% of the assets under management and 20% of any returns in excess of the 6% hurdle rate.

50. *Id.* at 15.

51. "Lock-up periods can range from six months to five years. Lock-up period restrictions apply to investors' ability to transfer or sell their interest in a hedge fund." Pierre-Louis, *supra* note 46, at 44.

52. MCCRARY, *supra* note 48, at 14.

B. COMMON HEDGE FUND STRATEGIES

"Hedge funds generally employ an absolute return approach to investing through which they seek to profit in a variety of market environments."[53] In order to preserve strategic flexibility, many—but not all—Hedge Funds use multiple strategies.[54] Since Hedge Funds "invest across diverse asset classes and types of securities," their investment portfolios feature a broad range of investment horizons and risk characteristics.[55] This section is not meant to provide a complete picture of how Hedge Funds make investment decisions—nor could it possibly do so. Instead, the discussion sheds light on *strategic features* affecting their decision-making.[56]

Long and short equity is the most common strategy employed by Hedge Funds and involves taking long and short positions in various

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53. STAFF REPORT TO THE U.S. SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 33 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

54. This feature serves two purposes. First, by diversifying the securities held by the fund, systemic risk is mitigated. *See* William Fung & David A. Hsieh, *The Risk in Hedge Fund Strategies: Theory and Evidence from Trend Followers*, 14 REV. FIN. STUDIES 313, 314 (2001). Second, funds allocated to a particular strategy can be re-allocated to a different strategy—in which the fund specializes—in response to market opportunities. *See, e.g.*, Gregory Connor & Teo Lasarte, *An Overview of Hedge Fund Strategies* 2, http://www.atrader.com/files/upl/pdf/nid/An-Overview-of-Hedge-Fund-Strategies.pdf.

55. STAFF REPORT TO THE U.S. SEC. & EXCH. COMM'N, *supra* note 49, at 33.

56. "Hedge Fund Research (HFR), one of the main hedge fund databases, lists 30 separate strategies (with some overlap between them). Another widely used database, TASS Research, separates hedge funds into 17 strategy types." Connor & Lasarte, *supra* note 54, at 3. Two other hedge fund databases—Van Hedge and CISDM—provide coverage of all hedge funds with Van Hedge offering "generic performance information on hedge fund styles." Hany A. Shawky & Achla Marathe, *Stylistic Differences Across Hedge Funds as Revealed by Historical Monthly Returns*, 2 TECH. & INV. 26, 27 (2010) [hereinafter Shawky & Marathe, *Stylistic Differences*]. Traditional risk management tools have been used to describe Hedge Fund strategies by asset class, direction, type, liquidity and geographical region. *See generally* Richard Bookstaber, *Hedge Fund Existential*, 59 FIN. ANALYSTS J. 19, 20 (2003) (describing various organizational approaches). Empirical approaches have also attempted to classify Hedge Fund strategies based on returns. *See generally* William Fung & David A. Hsieh, *Empirical Characteristics of Dynamic Trading Strategies: The Case of Hedge Funds*, 10 REV. FIN. STUDIES 275, 275–302 (1997) (identifying five distinct strategies); Shawky & Marathe, *Stylistic Differences*, *supra* (focusing on monthly returns and identifying four distinct strategies and, within two of those categories, eight sub-strategies).

equity securities.[57] A security purchaser is long when he or she stands to benefit from any increases in the security's value. A security purchaser is short when he or she stands to benefit from any decreases in the security's value.[58] Long and short portfolios are sometimes highly concentrated in specific sectors or even companies.[59] Long and short positions may also offset one another, resulting in net long positions or net short positions. This strategy can be used alongside the market-neutral techniques described below.[60]

Since many investment strategies generate concentrated risk attributes, Hedge Funds employ quantitative-based market-neutral strategies to mitigate systemic risk.[61] These strategies are often based on certain trading rules such as an opinion that a certain sector is more valuable than another, and feature little manager discretion.[62] Leverage is also commonly applied to market-neutral investing because the absolute amount of profit per trade can be small.[63]

Hedge fund managers also commonly use relative value strategies.[64] These strategies have been described as "picking up nickels in front of bulldozers."[65] They are designed to take advantage of perceived mispricing among related financial assets and are often based on "the long-run tendency of market prices to revert to equilibrium

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57. Jerald David August & Lawrence Cohen, *Hedge Funds – Structure, Regulation and Tax Implications*, *in* THE PARTNERSHIP TAX PRACTICE SERIES: PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2009, at 715, 722 (PLI Course Handbook, May-Jun. 2009).

58. Opening a short position involves borrowing and selling a security with the intent to purchase it back later for a lower price and return it to the borrower. A short-seller thus bears the risk that the security will increase in value. *See id.*

59. *See, e.g.*, MCCRARY, *supra* note 48, at 34 (Funds "can have substantial exposure to specific sectors and even individual companies.").

60. "A long/short position is created across different investment sectors or within a particular sector, based on quantitative models designed to dampen broad equity swings." August & Cohen, *supra* note 57, at 722.

61. *See, e.g.*, *id.* at 722.

62. *See, e.g.*, MCCRARY, *supra* note 48, at 36.

63. *See, e.g.*, Jongho Kim, *Can Risks Be Reduced in the Derivatives Market? Lessons from the Deal Structure Analysis of Modern Financial Engineering Debacles*, 6 DEPAUL BUS. & COM. L.J. 29, 73 (2007).

64. FILIPPO STEFANINI, INVESTMENT STRATEGIES OF HEDGE FUNDS 15 (John Wiley & Sons, Inc.) (2006) (50% of hedge funds employ relative value strategies, including merger arbitrage).

65. *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED 102 (Random House) (2000).

relationships."[66] The simplest example of a relative value trade involves identifying a price divergence between two historically related stocks and being short the historically over-valued stock and long the historically under-valued stock. Typically, Hedge Funds will use derivatives to offset their "exposure to the price movements of the underlying securities, interest rates, and broad market movements."[67] Since the pricing discrepancy is usually small, this strategy is also often highly leveraged.[68] Relative value strategies can include convertible arbitrage,[69] fixed income arbitrage,[70] and pricing inefficiencies[71] in bonds, government securities, or a company's debt and equity.[72]

Other common Hedge Fund strategies are also widely used. Macroeconomic strategies make large, leveraged bets on "major macroeconomic events such as changes in interest rates, currency movements and stock market performance."[73] The strategy is not market-neutral and "relies on the ability to make superior forecasts" and decisive execution.[74] Similarly, emerging market strategies incorporate many of the above-discussed strategies, with a focus on developing countries.[75] Managed future strategies focus on "equity index futures, fixed income futures, options on individual equities and commodity

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66. Connor & Lasarte, *supra* note 54, at 8.

67. *Id.*

68. *Id.*

69. A convertible arbitrage strategy seeks to profit from an undervaluation in the market of a bond or preferred stock that is convertible to equity. Investors "typically take a long position in the convertible bond and short the company's equity. In doing so, the investor takes advantage of the undervaluation of the convertible bond while reducing the exposure to the underlying stock price movement." *See generally id.* at 8–9.

70. "[P]rofits are attained by exploiting pricing inefficiencies between related fixed income securities, while exposure to interest rate risk is neutralized…." August & Cohen, *supra* note 57, at 722.

71. "[I]nvestment decisions are based on quantitative models for statistical arbitrage . . . ." *Id.*

72. Connor & Lasarte, *supra* note 54, at 10–11.

73. *Id.* at 7; Shawky & Marathe, *Stylistic Differences*, *supra* note 56, at 27.

74. Connor & Lasarte, *supra* note 54, at 7.

75. "This strategy involves equity or fixed income investing in emerging markets around the world. Because many emerging markets do not allow short-selling, nor offer viable futures or other derivative products with which to hedge, emerging market investing often employs a long-only strategy." Mila Getmansky et al., *Shifting Through the Wreckage: Lessons from Recent Hedge Fund Liquidations*, *in* THE WORLD OF HEDGE FUNDS: CHARACTERISTICS AND ANALYSIS 7, 41 (H. Gifford Fong, ed., World Sci. Publ'g Co. Pte. Ltd. 2005).

futures."[76] Fund of funds strategies assume Hedge Funds are a unique asset class and invest across managers and strategies in order to mitigate non-systemic market risk and benefit from diversification.[77]

C. TAKEOVER STRATEGIES: ACTIVISM AND MERGER ARBITRAGE

Event-driven strategies seek special corporate opportunities and rely largely on fundamental analysis to make investment decisions.[78] Two particular types of event-driven strategies—activism and merger arbitrage—play a major role in attempted takeovers. Section C.1 describes how activism works and how it affects takeovers. Section C.2 explains how merger arbitrage works and how it affects takeovers.

1. Activism

Activist Hedge Funds typically use fundamental analysis[79] to identify favorable investments.[80] Approximately $50 billion—or 5% of global assets[81]—is committed to activist strategies. Activist strategies can further be divided into corporate governance and takeover strategies, the two not necessarily being mutually exclusive.[82] Corporate

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76. Shawky & Marathe, *Stylistic Differences*, *supra* note 56, at 33.

77. Na Dai & Hany A. Shawky, *Diversification Strategies and the Performance of Funds of Hedge Funds*, 1 (Working Paper, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1719749.

78. MCCRARY, *supra* note 48, at 37.

79. *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1383 (2007) ("[These funds] maintain concentrated portfolios and often avoid the hedged or multi-strategy approaches followed by other funds, with their managers tending to be former investment bankers or research analysts rather than quantitative experts. They do the research and know their targets well . . . .").

80. *See generally* Brian R. Cheffins & John Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds* 9–11 (U. Cambridge Faculty L. Research Paper No. 38/2011, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1932805 (describing Hedge Fund decision-making).

81. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1046 n.135 (2007) (citing 2006 J.P. Morgan report); Paul R. Kingsley, *Hedge Fund Activism and Its Impact on Corporate Boards*, *in* CORPORATE GOVERNANCE 2007: COUNSELING YOUR CLIENT FOR THE 2007 PROXY SEASON at 15, 17 (PLI Course Handbook, Jan. 17, 2007) (identifying "at least" $50b devoted to activist strategies as of 2007).

82. *See generally* Charles M. Nathan & Parul Mehta, *The Parallel Universes of Institutional Investors and Institutional Voting*, (Working Paper, 2010), *available at*

governance activism generally focuses on "advisory vote[s] on executive pay ('say-on-pay' proposals), majority voting in director elections, the right to call special meetings and independent board chairmanship . . . proposals for board declassification and poison pill redemption."[83] Takeover activism generally focuses on cash returns through "leverage, big dividends, recapitalizations, sales, and similar transactions that return capital immediately to shareholders."[84]

Overall, activism typically involves acquiring relatively small stakes[85] in under-valued companies[86] and "propos[ing] strategic, operational, and financial remedies."[87] Activist targets are often relatively small.[88] Hedge Funds leverage their relatively small ownership stakes in several ways. Funds may "target . . . several companies on similar issues,"[89] form alliances with influential shareholders—like Institutional Investors,[90]—or cooperate with

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papers.ssrn.com/sol3/papers.cfm?abstract_id=1583507 (describing Hedge Fund Activism within a Corporate Governance-Takeover framework).

83. Theodore N. Mirvis, *Takeover Law and Practice 2010*, *in* DELAWARE LAW DEVELOPMENTS 2011: WHAT ALL BUSINESS LAWYERS NEED TO KNOW, at 413, 434 (PLI Course Handbook, May 18, 2011).

84. Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 8 n.20 (2010).

85. *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance,* 63 J. FIN. 1729, 1732 (2008) ("The median maximum ownership stake for the entire sample is about 9.1%. Even at the 95th percentile in the full sample, the stake is 31.5%-far short of the level for majority control.").

86. *See id.* at 1730 (Hedge Funds often seek stakes in companies with two key features: low ratios of market value to book value (total cash value of company equity over balance sheet value of company equity based on assets less liabilities) and "sound operating cash flows and return on assets.").

87. *Id.* at 1729; *see also* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, J. CORP. L. 681, 695 (2007) (defining hedge fund activism as "any actual or overtly threatened proxy contest or any other concerted and direct attempt to change the fundamental strategic direction of any solvent United States public corporation other than a mutual fund. . . . For example, any campaign using such phrases as value '"maximization'" or '"enhancement'. . . .").

88. Bratton, *supra* note 79, at 1388.

89. *See* Brav et al., *supra* note 85, at 1733.

90. *See id.*; Strine, *supra* note 84, at 8 n.20 ("The 'governance activists' often amplify the power of the hedge funds by pushing corporate governance measures – such as the elimination of classified boards and other takeover defenses – that make boards more susceptible to immediate market pressures" (referencing William W. Bratton & Michael L. Wachter, *The Case against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 684 (2010) ("The hedge funds have inspired interventions by large,

management.[91] Activists are often successful[92] and, despite a reputation for management hostility, openly oppose management less than thirty percent of the time."[93]

Takeover activism in target stock holdings typically results in increased shareholder wealth.[94] However, gains attributed to this strategy can depend on merger consummation.[95] When mergers are not consummated, this strategy produces below-average returns.[96] As a result, takeover activists with target stock holdings are incentivized to favor merger consummation and can affect merger outcomes in several ways. Hedge Funds with significant target stakes agitate for higher quality consideration and initiate value-producing litigation.[97] Hedge Funds also launch takeover bids for those companies in which they are invested—as principal investors or as part of investment syndicates—and have also attempted to leverage their holdings to put the company into play.[98] Hedge Funds with significant acquirer stakes engage in

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mainstream investment advisors; they also have depended on and received the support of other, more passive institutional investors.”))).

91. *See* Brav et al., *supra* note 85, at 1733.

92. *See* Bratton, *supra* note 79, at 1405–06 (finding empirical eighty percent success in hostile takeovers); Brav et al., *supra* note 85, at 1732 (estimating two-thirds empirical success rate in hostile takeovers).

93. Brav et al., *supra* note 85, at 1732.

94. *See* Nicole M. Boyson & Robert M. Mooradian, *Hedge Funds as Shareholder Activists from 1994-2005*, 1, 1–4, 20 (July 31, 2007), *available at* http://ssrn.com/abstract=992739 (presenting results indicating that aggressive activism, focusing on obtaining a significant share of the target's stock, obtaining board control, and obtaining a variety of securities from the target, among other factors, "significantly improves short-term and long-term performance of target firms compared to non-targets" but that "passive activism" does not produce abnormal returns); Brav et al., *supra* note 85, at 1731 (finding abnormal returns for activism resulting in changes in business strategy takeovers, but not for governance-related activism); Robin Greenwood & Michael Schor, *When (Not) to Listen to Activist Investors*, HARV. BUS. REV., Jan. 2008, http://hbr.org/2008/01/when-not-to-listen-to-activist-investors/ar/1 (finding strong returns when a takeover occurs, but not otherwise); Jiekun Huang, *Hedge Funds and Shareholder Wealth Gains in Leveraged Buyouts* 24-25 (May 2009), *available at* http://ssrn.com/abstract=1086687 (finding large Hedge Funds holdings is associated with higher leveraged buyout premia).

95. *See* Greenwood & Schor, *supra* note 94.

96. *See id.*

97. *See generally* Kahan & Rock, *supra* note 81, at 1034–39 (describing Hedge Fund strategies in mergers).

98. *See, e.g.*, *id.* at 1040–42.

activism as well. However, where takeover activists with large target stock holdings prefer mergers to be consummated, takeover activists with large acquirer holdings have the opposite incentives and thus often oppose mergers[99] to avoid merger-related stock declines.[100]

While mainstream shareholders sometimes benefit from takeover activist strategies, their economic interests can sometimes conflict.[101] When Hedge Funds with significant short target positions oppose mergers through media campaigns[102] or litigation,[103] their managers' motivations are limited to their economic incentives. Hedge Funds may prefer a merger alternative featuring greater consideration while management prefers a synergy-creating union.[104] Hedge Fund managers might also favor merger outcomes that optimize[105] their holdings in merger party securities, like common shares, preferred shares, debt and options.[106]

The use of derivatives can also leverage a Hedge Fund's merger influence and exacerbate shareholder conflicts.[107] In at least two

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99. *See generally* Kahan & Rock, *supra* note 81, at 1034–39 (discussing Hedge Funds' incentives in mergers).

100. *See infra* note 136. *See generally* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 623–28 (1989) (discussing irrational overpayment by bidders in takeovers).

101. *See generally infra* Part IV (discussing whether the economic incentives of Hedge Funds and Institutions are aligned in the takeover context).

102. In the case of *In re* MONY Grp., Inc. S'holder Litig., 853 A.2d 661, 670 (Del. Ch. 2004), a Hedge Fund attempted to prevent consummation of a merger when it stood to profit from its short position in a specific type of convertible debt security if the merger failed. In order to protect its interest, the hedge fund published a newspaper advertisement urging rejection of the transaction, convinced a proxy advisory firm not to recommend the merger and started a website encouraging target shareholders to seek appraisal rights. *See* Kahan & Rock, *supra* note 81, at 1073.

103. In the case of High River Ltd. P'ship v. Mylan Labs, Inc., 353 F. Supp. 2d 487 (M.D. Pa. 2005), a Hedge Fund initiated litigation designed to prevent merger consummation when it stood to profit from its short position if the merger failed.

104. Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 582–83 (2006).

105. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1289 (2008).

106. *See* Hu & Black, *infra* note 107, at 835 (describing decoupling strategy of hedge funds, like using borrowed shares to profit from put options); *see also* Peter Lattman, *Fortress Clashes on Both Sides*, WALL ST. J., July 14, 2009, at C1 (discussing conflicts of interest when private equity firms, like Fortress, have both debt and equity in the same firm).

107. *See* Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775, 789–94 (2005) (describing seven situations where shareholders use derivatives to

instances, Hedge Funds entered into complex derivative transactions to enhance their voting power without incurring additional economic risk. In *High River Ltd. Partnership v. Mylan Labs*,[108] a Hedge Fund with a large target position arranged for two banks to borrow ten percent of the acquirer's shares and sell short to the hedge fund the shares to vote in the merger.[109] The Fund and the banks also entered into a total return swap on the same number of Mylan shares.[110] The swap required the fund to pay the banks any increases in share value, thereby offsetting the banks' short position in the acquirer, and for the banks to pay any decreases in share value to the fund, thereby offsetting the Hedge Fund's long position in the acquirer.[111] Thus, the Hedge Fund held no economic interest in the acquirer by virtue of the swap and, if the merger were consummated, the Hedge Fund would gain on its substantial pre-swap target holding when the target increased to the merger price.[112]

Similarly, in *CSX Corp. v. The Children's Investment Fund (UK) LLP*,[113] a Hedge Fund began building a significant position in CSX by entering into cash-settled total return swaps with several different banks.[114] The Hedge Fund sought to increase its interest in CSX to gain

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vary their short-term and long-term economic interests while retaining voting power); *see generally* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership,* 79 S.CAL L. REV. 811 (2006) (discussing the negative consequences resulting from shareholders acquiring voting rights with limited economic risk).

108. 353 F. Supp. 2d 487 (M.D. Pa. 2005).

109. Charles M. Nathan, *Merger Arbitrage, Beneficial Ownership Reporting and Proxy Contests: The SEC's Perry Order*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION 4 (Oct. 25, 2009), http://www.lw.com/upload/pubContent/_pdf/pub2854_1.pdf.

110. *See id.* A swap agreement in which one party makes payments based on a set rate, either fixed or variable, while the other party makes payments based on the return of an underlying asset. *See* Financial Derivative Terms, FINCAD, http://www.fincad.com/derivatives-resources/glossary/total-return-swap.aspx (last visited Nov. 12, 2012).

111. *See* Nathan, *supra* note 109, at 4.

112. The merger was not consummated for unrelated reasons. *See* Nathan, *supra* note 109, at 5. The SEC indicated that the Hedge Fund should have disclosed its ownership position, but found no other securities laws violations. *See id* at 5–6, 9.

113. 562 F. Supp. 2d 511, 523 (S.D.N.Y. 2008), *aff'd in part*, 292 F. App'x 133 (2d Cir. 2008) *and aff'd in part, vacated in part*, 654 F.3d 276 (2d Cir. 2011).

114. Total Return Swaps can either be cash-settled or settled-in-kind. A cash-settled swap is terminated when the Hedge Fund receives the cash equivalent of any appreciation and cash distributions (interest or dividends) generated by the underlying

board seats through a proxy contest,[115] and ultimately direct CSX's business strategy in accordance with its own economic interests. In fact, the fund at one point even contemplated the possibility of an LBO.[116] The Hedge Fund accumulated approximately fourteen percent of the voting power in CSX through a combination of derivative and physical holdings.[117] Initially, the Hedge Fund did not cause its physical holdings, nor the physical holdings of any of its counterparties to exceed five percent of CSX, which would have triggered mandatory disclosure under the Williams Act.[118] Eventually however, the Hedge Fund consolidated its derivative holdings into two counterparties, in part because they believed these banks would be more willing to vote the shares according to the Hedge Fund's wishes.[119] The Hedge Fund did not disclose its physical and derivative holdings to the SEC until officially coordinating with another Hedge Fund to act as a group for securities law purposes.[120] At that time, the Hedge Fund disclosed both its physical and derivative holdings. A suit was brought by CSX against the Hedge Fund alleging, *inter alia*, that the disclosure of beneficial ownership was not timely filed.[121] The District Court, relying on fact-specific analysis and without expressly deciding whether total return swaps necessarily constitute beneficial ownership for Williams Act purposes, held that the Hedge Fund did not file its disclosure in a timely fashion because the total return swaps in this instance constituted a violation of the anti-evasion provisions of the Williams Act.[122]

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security. *See id.* at 520. A settled-in-kind swap is terminated identically, except the Hedge Fund purchases the security in exchange for its price at a pre-determined, pre-sale reference date (i.e., the fifteenth day of the preceding month). *Id.*

115. *See id.* at 526.
116. *Id.*
117. *Id.*
118. *Id.* at 528–29.
119. *Id.* at 529–30.
120. *Id.* at 535–36.
121. *Id.* at 538.
122. *Id.* at 545–48.

2. Merger Arbitrage

What is Merger Arbitrage?

Merger arbitrage funds "seek to profit from trades involving change of corporate governance."[123] In a typical merger, the putative acquirer makes a tender offer or merger proposal to purchase the target company's shares for a significant premium. Once the merger is announced, shares of the target usually increase and shares of the acquirer usually decrease.[124] Target stock will generally continue to trade at a discount to merger consideration[125] because of the risk that the merger will not be completed.[126] This is the arbitrage opportunity.[127]

Merger Arbitrageurs

Once the merger is announced, traders and Hedge Funds known as "merger arbitrageurs" begin acquiring stakes in the merger parties,[128] and trading steadily increases until the merger is either consummated or fails.[129] Arbitrageurs make money in two ways: pre-merger sales of appreciated merger party securities and post-merger sales of merger consideration.[130] Even though arbitrageurs invest a relatively small

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123. MCCRARY, *supra* note 48, at 36.

124. *See* Stanley Block, *Merger Arbitrage Hedge Funds*, 16 J. APPLIED FIN. 88, 89 (2006) (citing 5-15% premia post-merger announcement for cash mergers).

125. Mark Mitchell et al., *Price Pressure around Mergers*, 59 J. FIN. 31, 35 (2004).

126. Empirical studies have identified certain material risks associated with merger arbitrage: "target's stock price run-up, termination fees, ownership in target's shares by bidding firm, target resistance, arbitrage spread, relative target size, transaction size, bidding competition, deal consideration structure, and bid premium." Jia Wang & Ben Branch, *Takeover Success Prediction and Performance of Risk Arbitrage*, 15 J. BUS. & ECON. STUDIES 1, 1 (2009). Other factors affecting non-consummation include rejection by shareholders, antitrust concerns, and the deteriorating financial condition of either merger party or the economy. Block, *supra* note 124, at 89.

127. *See* Mark Mitchell & Todd Pulvino, *Characteristics of Risk and Return in Risk Arbitrage*, 56 J. FIN. 2135, 2138 (2001) (finding 4% risk arbitrage returns for mergers between 1963 and 1998 after adjusting for transaction costs).

128. Keith M. Moore et al., *The Behavior of Risk Arbitrageurs in Mergers and Acquisitions*, 9 J. ALT. INV. 19, 26 (2006).

129. Francesca Cornelli & David D. Li, *Risk Arbitrage in Takeovers*, 15 REV. FIN. STUDIES 837, 837 (2002).

130. *See* MCCRARY, *supra* note 48, at 36, 37 ("The success of a particular [merger arbitrage] trade hinges almost entirely on whether the announced deal is completed.");

amount of their portfolios in any single transaction,[131] as a group they often number between thirty and forty percent of all stockholders during the period after the merger is announced.[132]

Arbitrageurs are relatively risk-averse[133] and generally support mergers.[134] While it is possible to profit by betting against a merger succeeding,[135] the unexpected failure of a few transactions can completely eliminate annual profits of merger arbitrageurs betting in favor of merger consummation.[136] Mergers are consummated nearly ninety percent of the time[137] and arbitrageurs determine whether or not

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see also Cornelli & Li, *supra* note 129, at 838; Jim Hsieh & Ralph A. Walkling, *Determinants and Implications of Arbitrage Holdings in Acquisitions* 6 (Tuck Contemporary Corp. Fin. Issues III Conference Paper; Dice Ctr. Working Paper No. 2003-14, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=571022 ("Unlike small shareholders or noise traders, arbitrageurs tend to accumulate blocks of target shares after an acquisition announcement and sell their shares to the bidder at resolution of the offer."); Mitchell et al., *supra* note 125, at 35 ("[I]f the merger fails, the target firm's stock price usually falls dramatically, generating a large negative return. Merger arbitrageurs are compensated for bearing this transaction risk.").

131. *See* Moore et al., *supra* note 128, at 26 (noting that arbitrageurs generally limit the size of their trades to approximately ten percent of a mean $150 million portfolio).

132. Cornelli & Li, *supra* note 129, at 838; Mitchell et al., *supra* note 125, at 34 (citing forty per-cent acquirer short interest in fixed stock consideration mergers).

133. *See* Defendants' Post-Supplemental Hearing Memorandum at 16, Air Prods. & Chems., Inc. v. Airgas Inc., 16 A.3d 48 (2010) (5249-CC, 5256-CC), 2011 WL 396487, at *16 (Arbitrageurs "are more likely to be risk averse than risk loving (although risk tolerance will also vary depending upon the size of the firm, investment strategies, etc.)" (citing ISS report)).

134. *See, e.g.*, *id.* (Arbitrageurs' "willingness to 'leave some money on the table in exchange for an earlier and more certain pay out' . . . 'can make [them] a hostile acquirer's best ally.'") (citing ISS report).

135. *See* Dion Friedland, *About Hedge Funds – Reducing Market Risk with Merger Arbitrage*, MAGNUM FUNDS, *available at* http://www.magnum.com/hedgefunds/reducingmarketrisk.asp ("Others, anticipating failed deals, short the target's stock. For example, Paulson Partners shorted the stock of AEL Industries Inc., a supplier of electronic systems and subsystems, after acquisition plans by another company were reported to be on shaky ground."); *see also infra* note 143 (providing merger arbitrage calculation).

136. Ben Branch & Taewon Yang, *A Test of Risk Arbitrage Profitability*, 15 INT'L REV. FIN. ANALYSIS 39 (2006) (finding that the failure of six of one hundred merger attempts in 2002 resulted in a 5.7 percent loss).

137. Block, *supra* note 124, at 89 ("[T]he median probability of successful consummation of all mergers is 89%. However, the success rate is slightly higher for flexible stock for stock exchanges (93%), and slightly lower for cash and fixed stock for stock exchanges (87 and 88%, respectively).").

to support a merger based on its offer characteristics and other factors affecting consummation.[138] Arbitrageurs exhibit skill in identifying high-likelihood mergers:[139] mergers with greater arbitrageur holdings are more likely to be consummated[140] and arbitrageurs avoid offers unlikely to result in a merger, such as those with especially high takeover premia.[141] Arbitrageurs also exhibit skill in affecting merger outcomes: increased holdings are associated with greater likelihood of consummation, increased bid premia, and higher arbitrage returns.[142]

Merger arbitrage is conducted through various strategies of differing complexity and the choice of strategy depends, in part, on the consideration offered in the merger. This section discusses merger arbitrate strategies associated with mergers involving (i) cash consideration, (ii) fixed stock consideration, (iii) floating stock consideration, and (iv) stock consideration with collars.

Merger Option 1: Cash Consideration

Cash mergers present the simplest arbitrage opportunity. The expected return on a cash transaction is the probability that the merger will be consummated multiplied by the difference between the merger consideration and the stock purchase price, plus the probability that the merger will not be consummated multiplied by the difference between the stock purchase price and the stock price prior to the merger announcement.[143]

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138. *See id.* ("[A] friendly negotiated offer is 20.48 times more likely to succeed than a hostile tender offer."). *See generally supra* note 126 (describing merger consummation risks).

139. *See* Hsieh & Walkling, *supra* note 130, at 5–6 (discussing evidence of arbitrageurs "anticipat[ing] deal success rates").

140. *See id.*; Neiliane Williams, Arbitrageur Activity and Market Anticipation in Predicting Takeover Success 9 (Mar. 2009) (unpublished M.S. thesis, Concordia University) (on file with ProQuest Dissertations and Theses) (finding evidence that post-merger announcement stock price run-up correlates with merger success).

141. Ben S. Branch & Jia Wang, *Risk-Arbitrage Spreads and Performance of Risk Arbitrage*, 11 J. ALT. INV. 9 (2008).

142. *See* Hsieh & Walkling, *supra* note 130, at 36 (discussing evidence that merger arbitrageurs "exert active influence in the takeover market").

143. This formula can be expressed in terms of annual returns as:
$[C * G - L * (100 - C)]/[Y * P]$ where C is the probability of merger consummation, G is the positive return of the merger consideration less the security purchase price, L is

Merger Option 2: Fixed Stock Consideration

When merger consideration is in a fixed ratio of stock instead of cash, analyzing the expected transaction value and determining an appropriate arbitrage strategy is more complicated.[144] Say Company A offers Company T 0.5 shares of Company A stock worth $80 for every share of Company T stock worth $35 on the day of announcement.[145] Company T shareholders should be concerned that Company A stock will decline and decrease the aggregate transaction value. In order to lock in merger consummation gains, a Company T stockholder will short[146] 0.5 shares of Company A stock for every Company T stock share that is held.[147] "A similar merger arbitrage position as described above can also be constructed with options. Instead of short selling [Company A] shares, an investor can sell call options and buy put options with the same maturity date and exercise price."[148] In order to hedge against the possibility that the merger will not be consummated and that the investor has an unprotected short position in Company A,

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the negative return of the security purchase price less the pre-merger-announcement security price, Y is the holding period and P is the security purchase price.

144. Empirical accounts of arbitrageur trading patterns match predictions about how this basic trade operates. Thus, in a fixed stock consideration merger, median short interest in acquiring firms is forty percent. *See* Mitchell et al., *supra* note 125, at 34 (confirming the prediction that arbitrageurs will purchase sizeable short stakes in the acquirer to hedge against merger non-consummation).

145. *See id.* at 33 (commenting that most stock mergers involve fixed consideration ratios and describing the mechanics of the trade).

146. "Preparation for a short sale begins with a request that the arbitrageur's broker find a lender for the shares that are to be sold. The universe for potential lenders include the broker itself if it has an inventory of the desired stock, or institutional investors, including pension funds, insurance companies, and index funds . . . . The arbitrageur transfers collateral to the lender in the amount of 102% of the value of the borrowed securities, typically in cash. The lender then pays interest to the arbitrageur on the cash collateral, termed the rebate rate, and has the right to call the loan at any time." Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 728 (2003).

147. Consider that Company T shareholders expect a $5 return on each $35 share that is being exchanged for one-half Company T share. Selling short the one-half Company A share for $40 provides the shareholder with $40 cash and the obligation to turn over one-half Company A share on the date of merger. If Company A's half-share declines to $35, the Company T shareholder still has a $5 return.

148. Arco Wagemakers, *BofA/Countrywide Merger Arbitrage Opportunity*, SEEKING ALPHA, http://seekingalpha.com/article/66797-bofa-countrywide-merger-arbitrage-opportunity.

the Company T stockholder should buy a call option[149] or sell a put option[150] on Company A stock.[151]

Merger Option 3: Floating Stock Consideration

A variation of the fixed ratio stock merger is the floating ratio stock merger. Here, Company A proposes an all-stock merger with Company T for a fixed value of Company A shares. The value in Company A shares is determined by Company A's average price during a designated pricing period.[152] For the arbitrageur, the transaction is the same as a cash merger before the pricing period–because the consideration is fixed—and the same as a fixed ratio merger post-pricing period—because the consideration is now variable.[153] Thus, the arbitrageur will adopt the above-described strategies for each period: purchasing target stock pre-pricing period and acquiring short positions post-pricing period.[154] Arbitrageurs have particular difficulty pricing this trade due to information constraints and value fluctuations.[155]

149. A call option is the right to purchase a security for a fixed price (the strike price) on a fixed date plus the price of exercising the option. For example, the right to purchase one share of Company A stock for $75 on the date of merger with a $1 exercise price is a call option.

150. A put option is the right to sell a security for a fixed price (the strike price) on a fixed date plus the price of exercising the option. For example, the right to sell one share of Company A stock for $75 on the date of merger and a $1 exercise price is a put option.

151. Buying a call option on the Company A stock enables the Company T to cover its short position for the option exercise price plus the strike price (and the initial option price). Exercising the option will be less expensive than purchasing the security in the market when the market price exceeds the strike price plus the option exercise price. Selling a put option on the Company A stock allows the Company T stockholder to receive the initial option price. The option holder will only exercise the option if the security's market price is less than the strike price plus the exercise price.

152. Mitchell et al., *supra* note 125, at 36.

153. *Id.*

154. *Id.*

155. *Id.* at 33 (describing arbitrageur difficulties pricing floating stock merger trades with limited information); *see also* Block, *supra* note 124, at 91 (discussing 2001 merger of two insurance companies featuring floating stock consideration and collars).

Merger Option 4: Stock Consideration with Collars

Variations of stock consideration mergers may further increase the complexity of the arbitrage trade.[156] Some mergers involve "collars," which define the applicable range of consideration to be used in the merger.[157] A fixed stock consideration "collar" sets the minimum and maximum value of acquirer shares to be used in the transaction.[158] For example, Company A proposes a merger with Company T where 1 share of Company A stock, currently worth $10, will be exchanged for 2 shares of Company T stock, currently worth $4.50 each. A "collar" provision is negotiated guaranteeing that, regardless of price changes, the consideration, in Company A shares, for each Company T share will be no less than $9 and no more than $11. A "collar" provision could instead be negotiated guaranteeing that, regardless of price changes, the consideration, in Company A shares, for each Company T share, will be no less than 0.9 shares and no more than 1.1 shares.[159]

III. WHAT ARE THE PREFERENCES AND INCENTIVES OF INSTITUTIONAL INVESTORS?

Part III will provide a basis to explain Institutional Investors' incentives and preferences. Section A provides a background of the Institutional Investors landscape. Section B develops their economic interests by analyzing their investment characteristics and investing approaches. Section C discusses Institutional Investor responses to anticipated takeovers.

A. WHAT IS AN INSTITUTIONAL INVESTOR?

Mutual funds, pension funds, insurance companies, and foundations make up the universe of Institutional Investors.[160] It should be noted

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156. *See generally* Mitchell et al., *supra* note 125, at 37–38 (describing stock merger consideration variations).

157. *Id.*

158. *Id.* at 37.

159. *Id.*

160. Ben W. Heineman, Jr. & Stephen Davis, *Are Institutional Investors Part of the Problem or Part of the Solution?*, *in* NINTH ANNUAL DIRECTORS' INSTITUTE ON CORPORATE GOVERNANCE, at 55, 61 (PLI Course Handbook, Sept. 7, 2011) ("At the end of 2009, there were more than 700,000 pension funds, 8,600 mutual funds, 7,900 insurance companies in the US alone.").

that retail investors[161] will not be discussed in this Note because they have little effect on corporate events[162] and are, in large part, the beneficiaries of mutual funds and pension funds.[163] Mutual funds alone constitute the "largest shareholder category in U.S. public markets,"[164] and the industry is dominated by a small number of large funds.[165] There are three major types of pension funds: public pension funds organized for the benefit of state and local government employees, which are often advised by political officials; labor-union pension funds organized for the benefit of union members;[166] and private pension funds organized for the benefit of private-sector employees. In the aggregate, Institutions own more than half of the shares in the stock market.[167]

Institutional fund manager compensation bears some similarities to Hedge Fund manager compensation. Both forms of compensation typically include management fees and performance incentives,[168] but Institutional managers' performance-based compensation is limited by direct regulation and indirect pressure. Mutual fund managers are

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161. Retail Investors are "individuals with small stakes in a particular firm." *See* Lee Harris, *Missing in Activism: Retail Investor Absence in Corporate Elections*, 2010 COLUM. BUS. L. REV. 104, 104 (2010).

162. *Id.* at 104 ("[T]he evidence suggests that contested corporate elections are virtually off-limits as a conduit for [retail investor] activism. Retail investors almost never launch a campaign and their interests are not represented well by those who do.").

163. *Id.* at 131 fn.83 (describing retail investors as pension fund and mutual fund beneficiaries).

164. INVESTMENT COMPANY INSTITUTE, 2012 INVESTMENT COMPANY FACT BOOK 12 (52nd ed. 2012).

165. The largest twenty five firms managed seventy three percent of mutual fund assets in 2011, and the largest ten firms managed fifty three percent. *Id.* at 25.

166. A more detailed overview of public and labor-union pension funds appears in Anabtawi, *supra* note 108, at 588–89.

167. Jennifer E. Bethel et al., *The Market for Shareholder Voting Rights around Mergers and Acquisitions: Evidence from Institutional Daily Trading and Voting*, 15 J. CORP. FIN. 129, 129 (2009). *See generally* JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC 3 (U. Penn. Press) (2000) (characterizing Institutional Investors as "universal owners" with exposure to the entire economy).

168. *See* Gilchrist Sparks, III & John P. DiTomo, *The Short-Term Vs. Long-Term Dilemma*, *in* NINTH ANNUAL DIRECTORS' INSTITUTE ON CORPORATE GOVERNANCE, 125, 130 (PLI Course Handbook, Sept. 7, 2011) (Performance-based compensation for pension fund, mutual fund and endowment fund investment managers "often include[s] hurdle rates and exponential performance incentives."); *accord supra* notes 49–50 and accompanying text (describing Hedge Fund compensation arrangements).

directly regulated: they are permitted to receive management fees[169] and limited performance-based compensation,[170] but are barred from receiving capital-gain-based compensation.[171] Public pension fund managers are indirectly regulated: political pressure may limit government officials from authorizing generous compensation packages.[172]

B. COMMON INSTITUTIONAL INVESTOR STRATEGIES

Institutions employ a broad range of investment strategies.[173] A minority of Institutional Investors even invests in Hedge Funds.[174] Notwithstanding those allocations, Institutions generally favor diversified portfolios of liquid assets and typically avoid sophisticated investment techniques.

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169. MCCRARY, *supra* note 48, at 12.

170. *Id.* ("Although mutual funds can collect performance-based incentive fees, most do not, and the incentive fees are almost always smaller than the smallest hedge fund incentive fees.").

171. Investment Advisors Act of 1940, 15 U.S.C. § 80-b-5(a)(1) (2006) ("No investment adviser . . . [shall be compensated] on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client."). Registered Investment Companies–which include most mutual funds–are required to hire Registered Investment Advisors. 15 U.S.C. § 80-b-3(b)(3).

172. *See* Kahan & Rock, *supra* note 81, at 1057–59.

173. *See* Arik Ben Dor et al., *Understanding Mutual Fund And Hedge Fund Styles Using Return-Based Style Analysis*, *in* THE WORLD OF HEDGE FUNDS: CHARACTERISTICS AND ANALYSIS 63, 64 (H. Gifford Fong ed., World Sci. Publ'g Co. Pte. Ltd. 2005) ("For example, Morningstar, a prominent source of information on mutual funds, reports returns on four broad categories (domestic stock funds, international stock funds, fixed-income funds, and municipal bond funds) which are further divided into 48 sub-categories. The Investment Company Institute enumerates 33 investment objective categories.").

174. "80% of public pension funds, and 82% of corporate funds, have little or no investment in hedge funds." *See Concerning the Regulation of Hedge Funds: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 109th Cong. (July 25, 2006) (statement of Christopher Cox, Chairman, Sec. & Exch. Comm'n), *available at* http://www.sec.gov/news/testimony/2006/ts072506cc.htm. The remaining public pension funds allocate an average of 5.1%. *Id.* About two-thirds of foundations invest in Hedge Funds, with an average allocation of 18%. *See* Barbara T. Dreyfuss, *What Hedge Funds Risk*, AM. PROSPECT, (June 17, 2007), http://prospect.org/article/what-hedge-funds-risk; *Hedge Fund Sources of Capital*, THE HENNESSEE GROUP, http://www.hennesseegroup.com/information/info/SourcesofCapital 2005.pdf (Hedge Fund capital, as of 2005, is composed 14% from corporations, 7% from pension funds, and 7% from charitable foundations and endowments.).

1. Investment Characteristics

Most Institutions are required by state or federal law to invest in highly liquid assets and maintain well-diversified portfolios.[175] Mutual funds advertised as "diversified" face significant regulatory requirements.[176] State-regulated public pension funds and insurance companies are often required to keep a stated percentage of their investment portfolios in liquid, publicly-traded securities.[177] Federally regulated private pension funds also "continue to place the bulk of their investments in public securities markets."[178] By contrast, less-regulated private foundations typically invest more capital in illiquid securities.[179] Institutional liquidity preferences and investment horizons also vary according to their beneficiaries' needs. Retail-investor-focused mutual fund managers prefer liquid, short-term investments[180] because they face daily withdrawals.[181] Insurance companies and pension funds have longer investment horizons because benefits will be paid further in the future.[182] Some mutual funds address liquidity and diversification

175. *See* Anabtawi & Stout, *supra* note 105, at 1278–79.

176. *See* Kahan & Rock, *supra* note 81, at 1049 (describing legal rules requiring many mutual funds to diversify).

177. Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 247 (2009). *But see* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1057–59, 1057 n.179 (2007) (noting that public pension funds, while subject to a prudent investor standard, are not statutorily required to diversify but may face political pressures requiring it).

178. *Id.*

179. *Id.* ("[T]hose [funds] that are more willing to embrace investment experimentation (endowment funds) have shown a willingness to increase their allocation to private securities markets.").

180. François Derrien et al., Investor Horizons and Corporate Policies 2 (Oct. 20, 2009) (unpublished working paper), *available at http://www.efmaefm.org/0EFMAMEETINGS/EFMA ANNUAL MEETINGS/2010-Aarhus/EFMA2010_0159_fullpaper.pdf*; Jose-Miguel Gaspara et al., *Shareholder Investment Horizons and the Market for Corporate Control*, 76 J. FIN. ECON. 135, 136 (2005); *see also* Anabtawi, *supra* note 104, at 579 (noting that mutual funds turnover their shares about once a year, one-third as often as Hedge Funds).

181. MCCRARY, *supra* note 48, at 11.

182. Derrien et al., *supra* note 180, at 1–2; Gaspara et al., *supra* note 180, at 136. *But see* Heineman & Davis, *supra* note 160, at 67 (discussing long-term investment constraints for pension funds, life insurance companies and foundations, but noting inapplicability of this analysis to mutual funds).

restrictions by allocating funds to low-cost, passive investment strategies.[183] These so-called index funds are designed to produce the returns of all the stocks on an index like the S&P 500 while minimizing transaction costs (i.e. trades) for beneficiaries.[184]

2. Investment Approaches

Institutional Investors tend to avoid many of the investment techniques favored by Hedge Funds.[185] Indeed, they rarely invest borrowed funds[186] and are often contractually prohibited from short-selling.[187] While Institutions typically offset portfolio risks with simple hedging derivatives,[188] many are not permitted to use more sophisticated

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183. Anabtawi & Stout, *supra* note 105, at 1276. *But see* Sparks & DiTomo, *supra* note 168, at 130 ("Mutual funds and other asset managers often forego long-term strategies through churning portfolios to attract new investments for the next quarter.").

184. *See* Anabtawi, *supra* note 104, at 579 n.82.

185. *Compare supra* notes 186–90 and accompanying text *with supra* notes 53–56, 60–77 and accompanying text.

186. Mutual funds do not usually use leverage and it "almost never exceeds 2:1." MCCRARY, *supra* note 48, at 11. Insurance companies employ minimal leverage and most defined-contribution and corporate pension funds do not use leverage at all. Nikola Spatafora, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks*, *in* THE GLOBAL FINANCIAL CRISIS 2009: PREPARING FOR THE FUTURE, 319, 388 (PLI Course Handbook, Aug. 5, 2009).

187. *See, e.g.*, Andres Almazan et al., *Why Constrain Your Mutual Fund Manager?*, 73 J. FIN. ECON. 289, 295 (2004) (reporting two-thirds of mutual fund management contracts restrict short sales); *see also* Investment Company Act of 1940, 15 U.S.C. § 80a-12(a)(1)-(3) (2006) ("It shall be unlawful for any registered investment company . . . to purchase any security on margin . . . or to effect a short sale of any security. . . .").

188. "A mutual fund may invest in derivatives for a variety of reasons, including for 'hedging' (*i.e.*, risk reduction) purposes and as a substitute for investment in 'traditional' securities." Alison M. Fuller, *Derivatives*, *in* INVESTMENT COMPANY REGULATION AND COMPLIANCE, 181, 183–84 (ALI-ABA Course of Study, July 21–22, 2011). *But see SEC Seeks Public Comment on Use of Derivatives by Mutual Funds and Other Investment Companies*, SEC. & EXCH. COMM'N, *http://sec.gov/news/press/ 2011/2011-175.htm*. Mutual funds, insurance companies and pension funds are large derivative buyers. Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, The Problem of Hindsight Bias, and the Credit Default Swap Solution*, 2011 COLUM. BUS. L. REV. 118, 185 (2011). Pension funds engage in swaps to offset their interest rate and inflation risk. Jonathon Keath Hance, Note, *Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm,* 65 WASH. & LEE L. REV. 711, 726 (2008).

derivatives.[189] Despite these restrictions, Institutions represent roughly one quarter of total end-users of credit derivatives.[190]

3. Strategies

Institutional activism is principally motivated by preserving shareholder wealth[191] and typically focuses on governance reforms.[192] While individual Institutions exhibit unique preferences for certain governance features,[193] they rarely mount electoral challenges.[194] Institutions also can support Hedge Funds' governance initiatives,[195]

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189. Pension Funds are typically barred from investing in index derivatives like futures and options. W. Thomas Connor, *The Evolving Nature of Exchange-Traded Product Regulation*, *in* FUNDAMENTALS OF MUTUAL FUNDS AND EXCHANGE-TRADED FUNDS 2011, 189, 197 (PLI Course Handbook, June 8, 2011). Mutual Funds are permitted to purchase these derivatives. MCCRARY, *supra* note 48, at 12.

190. U.S. GOV'T ACCOUNTABILITY OFFICE REPORT, GAO-07-716, CREDIT DERIVATIVES: CONFIRMATION BACKLOGS INCREASED DEALERS' OPERATIONAL RISKS, BUT WERE SUCCESSFULLY ADDRESSED AFTER JOINT REGULATORY ACTION 6 n.8 (2007), *available at* http://www.gao.gov/new.items/d07716.pdf ("The top five end-users of credit derivatives are banks and broker-dealers (44 percent), hedge funds (32 percent), insurers (17 percent), pension funds (4 percent), and mutual funds (3 percent).")

191. *See generally* Cheffins & Armour, *supra* note 80, at 7–8 (describing Institutional Investor decision-making).

192. Anabtawi & Stout, *supra* note 105, at 1276 ("A number of prominent Institutional Investors–including both mutual funds like Fidelity and Vanguard and pension funds like CalPERS–have emerged as activist investors willing to mount public relations campaigns, initiate ligation, and launch proxy battles to pressure corporate officers and directors into following their preferred business strategy."); Strine, *supra* note 84, at 8 n.20 (2010) ("Unlike activist investors in the hedge fund sense, corporate governance activists primarily agitate only about corporate governance."); Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 VAND. L. REV. 299, 310 (2008) (citing Institutional Investor activism in securities suits, Rule 14a-8 proposals and public pension fund attempts to influence management).

193. *See generally* Joseph McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors* at 20 (Tilburg L. Sch., Research Paper No. 010/2010, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571046 (comparing and contrasting the governance preferences of Hedge Funds, insurance companies, mutual funds and pension funds).

194. Harris, *supra* note 161, at 129 (noting that the vast majority of electoral challenges come from "private firms," notably Hedge Funds).

195. Brav et al., *supra* note 85, at 1748; Daniel A. Neff, *Takeover Law and Practice: 2008* 13, *in* FIFTH ANNUAL INSTITUTE ON CORPORATE, SECURITIES, AND

presumably believing their economic interests to be aligned.[196] Overall, there is mixed evidence that institutional activism generates long-term value.[197] However, pension funds exhibit skill in spurring governance reforms.[198]

Institutional investment decisions are also affected by extrinsic economic factors. Thus, demonstrating support for company management could require opposing a value-generating initiative because management opposes it.[199] Similarly, advancing common political causes could involve exerting pressure on company management.[200]

RELATED ASPECTS OF MERGERS AND ACQUISITIONS 317, 336 (Sept. 2008) ("In 2007, institutions and hedge funds launched campaigns against approximately 40 transactions."). The recent reduction in companies with poison pill defenses is considered a result of Institutional Investor-Hedge Fund cooperation. *Id.* at 15 (citing decline of S&P 500 companies with poison pills from 46% in 2005 to 28% in 2008).

196. *See* Kahan & Rock, *supra* note 81, at 1091–92; *see also* Andrea Zanoni, *Hedge Funds' Empty Voting in Mergers and Acquisitions: A Fiduciary Duties Perspective*, 9 GLOBAL JURIST, Nov. 2009, at 15, *available at* http://ssrn.com/abstract=1285589 (inferring that investors perceive hedge fund intervention as adding economic value).

197. *Compare* Thomas, *supra* note 192, at 310 n.21 (citing surveys showing little positive effect) *with* Claire E. Crutchley et al., *Shareholder Wealth Effects of CalPERS' Activism*, 7 FIN. SERVS. REV. 1 (1998) (finding that visible and aggressive institutional activism leads to substantial increases in shareholder wealth); Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227 (1996) (finding increased shareholder wealth for issuers that responded to targeting by CalPERS).

198. David Yermack, *Shareholder Voting and Corporate Governance* 24–25 (N.Y.U. Stern Sch. Bus. Working Paper Series, 2010), *available at* http://ssrn.com/abstract=1523562 (reviewing empirical studies of pension funds' monitoring ability).

199. Mutual funds and pension fund managers sometimes vote with company management and against value-generating resolutions due to perceived or actual pressure from management. *See* George W. Dent, *The Essential Unity of Shareholders and the Myth of Shareholder Short-Termism*, 35 DEL. J. CORP. L. 97, 119 n.89 (2010) (citing empirical studies and anecdotal evidence). Banks and insurance companies have also been identified as ex ante likely to favor management. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277, 1318 (1991). This effect also appears in mergers with low levels of shareholder support when investment managers may be voting to maintain business relationships or based on bullish investment opinions on the merged company, or on a desire to appear activist. *See* Bethel et al., *supra* note 167, at 130.

200. *See* Anabtawi, *supra* note 104, at 590 (discussing pressure by CalPERS, a public pension fund, on a company to accept union demands and end the strike of a powerful private union).

Proxy advisory firms also affect an Institution's decision-making.[201] These firms publish corporate initiative voting guidelines from the hypothetical perspective of a one to two year holding period stockholder.[202] ISS, the leading firm,[203] "exercises a great deal of influence over the vote of many of its clients and . . . these clients often hold an important part of the available vote."[204] Among Institutional Investors, mutual funds are particularly deferential to advisory recommendations.[205]

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201. Institutional Shareholder Services, PROXY Governance, Inc., Glass, Lewis & Company and Egan-Jones Proxy are the leading proxy advisory firms. *See* Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 650 (2009).

202. *See* INSTITUTIONAL SHAREHOLDER SERVICES, 2011 U.S. PROXY VOTING GUIDELINES SUMMARY (describing voting recommendations as based on a one to two year holder), *available at* http://www.issgovernance.com/files/ISS2011USPolicy SummaryGuidelines20110127.pdf.

203. "[Institutional Shareholder Services] claims over 1,700 institutional clients managing $26 trillion in assets, including 24 of the top 25 mutual funds, 25 of the top 25 asset managers and 17 of the top 25 public pension funds." Robert Daines et al., *Rating the Ratings: How Good are Commercial Governance Ratings?* 1 (Rock Ctr. for Corp. Governance Stan. Univ.Working Paper 1, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=*1152093*.

204. *See* Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 357-58 (Del. Ch. 2010), *aff'd* 15 A.3d 218 (Del. 2011); Choi et al., *supra* note 201, at 657 ([ISS] is "able to sway up to 30 percent of the vote in any particular proxy contest."); Paul H. Edelman & Randall S. Thomas, *Resetting the Trigger on the Poison Pill: Selectica's Unanticipated Consequences* 36 (Vand. Univ. L. Sch. L. & Econ. Working Paper No. 10-16, 2010), *available at* http://ssrn.com/abstract_id=1631941 ("Voting recommendations by ISS are viewed as influential, if not determinative, in proxy contests . . . . Institutional investors overwhelming use the services of ISS and the other third party voting advisors, and empirical research has shown that ISS's recommendations have an impact on the outcome in shareholder voting contests."). Legal scholars have criticized this trend. *See generally* Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384 (2009); Choi et al., *supra* note 201, at 649.

205. *See* James Cotter et al., *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1, 31 ("[M]utual funds voted consistently with ISS voting recommendations more than all shareholders. Given that we cannot break out the mutual funds' actual votes from the total vote captured in the all shareholder vote, this effect is likely to be even larger than what we are measuring with the currently available data."); Ying Duan, The Role of Mutual Funds in Corporate Governance: Evidence from Mutual Funds' Proxy Voting and Trading Behavior 12, 18 (Mar. 7, 2008) (unpublished Ph.D. dissertation, Boston College) (explaining that Mutual Funds

C. TAKEOVER STRATEGIES

Institutions protect portfolio wealth by monitoring company management before a takeover bid is attempted. Public pension funds exhibit particularly strong monitoring abilities.[206] In contrast, mutual funds are often ineffective long-term value monitors and generally favor merger bids.[207] Overall, longer pre-bid holding periods by Institutions tend to enhance shareholder wealth, whether a takeover is consummated or not.[208] Institutions also maximize economic wealth by influencing takeover outcomes.[209] Once a takeover bid is announced, Institutions typically acquire voting rights in the merger parties' securities.[210] Institutions usually retain these shares post-vote[211] and are particularly

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are more likely to vote against managers than to sell when ISS recommends management opposition), *available at* http://ssrn.com/abstract=1101809.

206. Lily Xiaoli Qiu, *Which Institutional Investors Monitor? Evidence from Acquisition Activity* 2–3 (Brown Econ. Working Paper Series No. 2004-21, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=521803 (suggesting increased public pension fund monitoring ability results from larger holdings).

207. *Id.* at 3–4 (discussing mutual funds' poor monitoring ability).

208. Target companies with shorter holding periods by Institutions are more likely to be acquired and typically receive lower premia. Gaspara et al., *supra* note 180, at 137–38. The authors believe that shorter holding periods by Institutions diminish company monitoring and weaken the company's bargaining position. *Id.* Consequently, they argue, target shareholders capture a reduced portion of the economic surplus available in the merger bid. *Id.*

209. Jarrad Harford et al., *Conflicts of Interests among Shareholders: The Case of Corporate Acquisitions* 25 (Mass. Inst. Tech., Sloan Research Paper No. 4653-07, 2007), *available at* http://ssrn.com/abstract=947596 (finding evidence that cross-owners may disagree about whether the transaction should proceed and hypothesizing that portfolio optimization is the underlying rationale); *see also* Anabtawi, *supra* note 104, at 585 (hypothesizing Institutional Investor opposition to the Oracle/PeopleSoft merger if the merger negatively affected the Investor's stakes in other PeopleSoft-using companies).

210. For example, Institutional Investors may purchase discounted acquirer shares post-merger-announcement in order to vote for the merger and gain on their target holdings. They also may use those shares to vote against the merger and avoid a post-merger acquirer share price decline. *See generally* Bethel et al., *supra* note 167, at 130; Kai Chen, Institutional Behavior of Trading Acquirer Stocks around Mergers and Acquisitions, *in* Essays on Corporate Control Transactions 42, 60 (May 11, 2009) (unpublished Ph.D. dissertation, The University of Wisconsin-Milwaukee) (on file with ProQuest Dissertations and Theses) (describing the behavior of Institutions post-merger announcement).

211. Bethel et al., *supra* note 167, at 130.

active in purchasing voting rights when they are cheaply available.[212] Since diversified Institutions generally "cross-own" both target and acquirer shares,[213] they usually determine whether or not to support a merger based on the aggregate economic effects on portfolio wealth.[214] Thus, an Institution hoping to manage a target company's pension funds may purchase acquirer shares to vote against a merger.[215]

IV. HEDGE FUNDS AND INSTITUTIONS LACK SIMILAR ECONOMIC INTERESTS

Part IV demonstrates that Hedge Funds and Institutional Investors lack similar preferences and incentives in takeovers. Section A begins by discussing the claim that Hedge Funds' takeover activities benefit all shareholders, including retail investors, Institutional Investors, holders of beneficial interests in Institutional Investors, or any other holder of stock, and finds mixed evidence of this assertion. Sections B through D discuss circumstances in which the interests of Hedge Funds and Institutional Investors can diverge. Section B describes shareholder risk tolerances and finds little risk tolerance overlap. Section C describes these shareholders' investment horizons and finds limited investment horizon overlap. Section D analyzes investment managers' compensation incentives and finds that these explain much of the overlap and dissimilarity between the economic incentives of Hedge Funds and Institutional Investors. Section E considers intra-shareholders conflicts of interest and finds that both Hedge Funds and Institutions sometimes oppose the interests of other shareholders, notably retail investors, holders of beneficial interests in Institutional Investors, and any other holder of stock.

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212. *Id.* at 130–31 (discussing increased purchasing by Institutions in low-probability mergers).

213. *See* Gregor Matvos & Michael Ostrovsky, *Cross-ownership, Returns and Voting in Mergers*, 89 J. FIN. ECON. 391, 392 (2008).

214. *See* Chen, *supra* note 210, at 60; Matvos & Ostrovsky, *supra* note 213, at 402–03 (finding for non-value-generating mergers, cross-owner acquirer shareholders were much more likely to vote in favor of the merger than acquirer-only shareholders).

215. Bethel et al., supra note 167, at 131.

A. The Value Proposition

There is mixed evidence that Hedge Funds' takeover strategies benefit all shareholders. Merger arbitrage can benefit all shareholders under limited circumstances. Increased merger arbitrage activity enhances takeover premia and improves the likelihood of merger consummation.[216] Thus, when a takeover is the only possible outcome, increased expected takeover premia necessarily benefits all stockholders. Of course, takeover bids are not always successful. Moreover, the takeover premia received by the target shareholder in a merger is not necessarily preferable to potential gains from rejecting a merger bid and continuing as a stand-alone company. While merger arbitrage strategies generate value for merger arbitrageurs, it is not clear that all shareholders benefit.[217]

In addition, takeover activism only enhances shareholder wealth when takeovers result.[218] Overall, the strategy generates value[219] and enjoys support by Institutions.[220] But the strategy is not always value-creating: unconsummated mergers generate below-average returns.[221] Thus, the strategy distorts economic outcomes: successful takeovers are value-creating and unsuccessful takeovers are value-destroying. Moreover, while the strategy may on average increase shareholder returns, such added returns may not adequately compensate shareholders for the increased risk of takeover failures. Allocating shareholders' increased expected value and greater return variance is not necessarily preferable to capturing any gains resulting from rejecting a merger bid and continuing as a stand-alone company. While takeover activism generates shareholder value overall, it is not clear that shareholders aggregately benefit in light of the increased risks.[222]

B. Risk Tolerance

Hedge Funds and Institutional Investors exhibit dissimilar tolerances for risk in several ways. While Hedge Funds make

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216. *See supra* notes 94–95, 140–42 and accompanying text.
217. *See, e.g.*, notes 95–96 and accompanying text.
218. *See supra* notes 95–96 and accompanying text.
219. *See supra* note 94.
220. *See supra* notes 195–96 and accompanying text.
221. *See supra* notes 95–96 and accompanying text.
222. *See supra* notes 92–93 and accompanying text.

concentrated investments[223] across the universe of asset classes,[224] most Institutions are directly or indirectly required to invest in highly liquid, diversified portfolios.[225] Their respective approaches to leverage, short-selling, and derivatives are instructive as well. While Hedge Funds liberally employ leverage[226] and frequently short sell,[227] Institutions largely avoid borrowing and may face short-selling restrictions.[228] Similarly, while Hedge Funds often enter into complex derivative transactions,[229] derivative use by Institutions is typically limited to basic hedging.[230] Hedge Funds also utilize activist strategies four times more often than Institutions.[231] By contrast, Institutional activism is typically motivated by wealth preservation.[232] Overall, Hedge Funds' and Institutions' respective investment characteristics exhibit dissimilar risk tolerance.

C. INVESTMENT HORIZON

While Hedge Funds and Institutions each exhibit short-term biases, Hedge Funds' respective preference is more pronounced. Trading data indicate that Hedge Funds purchase and sell securities far more often

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223. *See* Harris, *supra* note 161, at 131 ("The high concentration of these funds makes them very dissimilar to the investment portfolio of the average shareholder, who owns a stake in a fully-diversified pension fund or mutual fund.").

224. *See* MCCRARY, *supra* note 48, at 11 ("The range of assets within a particular mutual fund is much smaller than that of a hedge fund.").

225. *See supra* notes 175–81 and accompanying text.

226. *See supra* notes 63, 68 and accompanying text.

227. *See supra* notes 57–60 and accompanying text.

228. *See supra* notes 186–87 and accompanying text.

229. *See supra* notes 105–22 and accompanying text.

230. *See supra* notes 188–90 and accompanying text.

231. *See* Robin Greenwood & Michael Schor, *Hedge Fund Investor Activism and Takeovers* 22 (Harv. Bus. Sch. Working Papers, Paper No. 08-004, 2007), *available at* http://hbs.edu/research/pdf/08-004.pdf. Moreover, Institutional Investors do not lead the majority of challenges. *See* Harris, *supra* note 161, at 129 ("If public pension funds, mutual funds, or similar institutions, were launching the majority of challenges there might be good reason to believe that the interests of small retail investors were being served in those contests. Such institutions are likely more responsive to the preferences of small shareholders, since they likely draw their capital directly from a diverse investor class.").

232. *See generally* Cheffins & Armour, *supra* note 80, at 7–11 (comparing Institutional Investor and Hedge Fund decision-making).

than do average market participants,[233] and three times more often than mutual funds.[234] In contrast to a Hedge Fund portfolio's broad investment spectrum,[235] Institutional allocations exhibit far narrower liquidity preferences, which reflect their beneficiaries' needs.[236] Yet while trading data and liquidity preferences demonstrate that Institutions are less short-term oriented than Hedge Funds, Institutional short-term biases manifest in other ways. Indeed, Institutions prefer short-term earnings increases over long-term value.[237] Investment manager compensation incentives also encourage short-term biases for Institutions and Hedge Funds alike.[238]

Hedge Funds' takeover strategies also exhibit signs of short-term biases compared to Institutions. Merger arbitrage presents a contrast in shareholder continuity. While merger arbitrageurs liquidate their holdings as soon as possible,[239] Institutions avoid liquidating voting rights purchased specifically to affect takeover outcomes.[240] In addition, activist holding period data provides limited, conflicting evidence of Hedge Funds' relative short-term biases. While some studies find

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233. *NYSE Group Turnover*, NYSE TECHNOLOGIES, www.nyxdata.com/factbook (choose Market Activity chapter hyperlink; then select NYSE Group Turnover hyperlink) (detailing one-year average annual turnover for NYSE-listed companies).

234. Anabtawi, *supra* note 104, at 579 (comparing 117% Mutual Fund turnover rate to Hedge Fund turnover rate).

235. *See supra* note 55 and accompanying text.

236. *See supra* notes 180–84 and accompanying text.

237. *See* Brian Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?*, (U. Pa. Working Paper Series, 1999) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=161739 (discussing Institutional short-term biases). *But see* Kahan & Rock, *supra* note 81, at 1085 ("[T]he empirical evidence on the extent and magnitude of [Institutional] myopia is sketchy at best.").

238. Heineman & Davis, *supra* note 160, at 67 (citing the 2011 World Economic Forum report for support that "'the goals and objective of the investment decision-maker might not be aligned with those of the beneficiaries of the investment fund' owing in part to skewed compensation schemes, risk measures that penalize managers who favor long-term investments, and career considerations.").

239. MCCRARY, *supra* note 48, at 36 ("In some cases, the funds can unwind positions early if prices of the company shares reflect most of the profit potential."); Moore et al., *supra* note 128, at 26 (noting that arbitrageurs sell their long positions when transactions are cancelled). Arbitrageurs limit the size of their trades to approximately ten percent of a mean $150 million portfolio. *Id.*

240. *See supra* notes 209–12 and accompanying text.

evidence of comparatively short Hedge Fund holding periods,[241] other studies indicate that activists maintain target stakes[242] as long as other shareholders.[243]

D. INVESTMENT MANAGER COMPENSATION

The similarities and differences between Hedge Funds' and Institutions' investment horizons and risk tolerances can be explained by their investment manager compensation incentives and investment restrictions. Common investment manager incentives likely account for both types of shareholders exhibiting short-term biases.[244] Indeed, since each investment manager is compensated for achieving performance benchmarks,[245] both should favor short-term increases that achieve those benchmarks. However, short-term biases of Institutions are dampened by restrictions on investment manager compensation[246] and liquidity, and by diversification requirements that limit managers' investment allocations.[247] Those requirements also instill in fund managers of Institutions with a relatively lower risk tolerance.[248] In contrast, Hedge Fund managers' risk preferences are incentivized by a compensation structure rewarding the highest investment returns,[249] complemented by a flexible, sophisticated investment vehicle.[250]

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241. Greenwood & Schor, *supra* note 231, at 13 (finding non-Hedge Fund shareholders have a twenty-one month median holding period compared to a four month Hedge Fund holding period).

242. Bratton, *supra* note 79, at 1412–13 (empirically finding that Activist Hedge Funds often hold stakes for one to two years); Brav et al., *supra* note 85, at 1731–32 (finding evidence of twelve month holding period but considering the data incomplete and arguing that the actual holding period is closer to twenty or twenty-two months).

243. *Compare supra* note 241 *with supra* note 242.

244. *See generally supra* Part IV.C.

245. *See supra* notes 48–52, 168–72 and accompanying text.

246. *See supra* notes 169–72 and accompanying text.

247. *See supra* notes 175–90 and accompanying text.

248. *See supra* Part IV.B.

249. *See supra* notes 48–52 and accompanying text.

250. *See supra* Parts II.B.–C. (discussing Hedge Fund strategies); *see also* Brav et al., *supra* note 85, at 1773 (Hedge Fund managers "have very strong personal financial incentives [because they are mainly paid based on performance] . . . and do not face the regulatory or political barriers that limit the effectiveness of [institutional investors].").

E. INTRA-SHAREHOLDER CONFLICTS

Both Hedge Funds and Institutions sometimes advance their economic interests at the possible expense of other shareholders' wealth. Hedge Funds commonly oppose other shareholders' interests when they engage in short-selling,[251] use derivative contracts,[252] or make investment-decisions based on a unique bundle of ownership interests.[253] Hedge Funds initiating litigation or media campaigns to protect short positions can also be at odds with other investors.[254] Similarly, Institutions can negatively affect other shareholders by opposing corporate initiatives for Institution-specific business reasons,[255] pressuring company management to support an Institution-favored political agenda,[256] or determining whether or not to vote for a merger based on optimizing their aggregate economic interests.[257]

V. HOW DOES THIS ANALYSIS COMPLEMENT OR REBUT EXISTING TAKEOVER ANALYSIS?

Part V considers how the dissimilar preferences and incentives of Hedge Funds and Institutional Investors both complement and rebut existing takeover analysis. Section A compares the findings in Part IV to academic commentary that seeks to explain when mergers should be consummated. Section B argues that, despite its reservations, the *Airgas* court's protection of the poison pill was the optimal conclusion in light of existing evidence.

A. THE ACADEMIC CASE FOR REFORM LACKS SUPPORT

The preceding framework of dissimilar shareholder economic interests[258] closely matches models offered by leading takeover jurisprudence scholars Martin Lipton[259] and Lucian Bebchuk,[260] as well

251. *See supra* notes 102–03 and accompanying text.
252. *See supra* notes 107–22 and accompanying text.
253. *See supra* notes 105–06 and accompanying text.
254. *See supra* notes 102–22 and accompanying text.
255. *See supra* note 199 and accompanying text.
256. *See supra* note 200 and accompanying text.
257. *See supra* notes 209–15 and accompanying text.
258. *See generally supra* Part IV.B.
259. Martin Lipton is a Partner at Wachtell, Lipton, Rosen & Katz LLP. *See Martin Lipton*, WACHTELL, LIPTON, ROSEN & KATZ, http://www.wlrk.com/Page.cfm/Thread/Attorneys/SubThread/Search/Name/Lipton, Martin.

as by behavioral finance theorists.[261] These paradigms contradict[262] Frank Easterbrook's[263] corporate governance model of "homogenous" shareholders exhibiting preferences that are "likely to be similar if not identical."[264] Lipton conceives shareholders as a diverse body affected by different investment horizons,[265] constituency obligations,[266] and other investor-specific motives.[267] Similarly, Bebchuk's academic work discusses shareholders' incongruent holding periods[268] and pursuit of special interests.[269]

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260. Lucian Arye Bebchuk is a Professor at Harvard Law School. *See Professor Lucian Arye Bebchuk*, HARVARD LAW SCHOOL, http://www.law.harvard.edu/Faculty/bebchuk/.

261. *See generally* Donald C. Langevoort, *The Behavioral Economics of Mergers and Acquisitions*, 12 TENN. J. BUS. L. 65 (2011); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, And Securities Regulation*, 81 VA. L. REV. 611 (1995).

262. *See* Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 462–64 (2005) (discussing and rejecting the assumption of shareholder homogeneity); *see also supra* Parts IV.B.-D.

263. Frank Easterbrook is Chief Judge of the United States Court of Appeals for the Seventh Circuit and Senior Lecturer in Law at The University of Chicago Law School. Frank Easterbrook—Biography, http://www.law.uchicago.edu/faculty/easterbrook.

264. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983).

265. *See* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 746 (2007) ("[C]ertain vocal shareholders, notably hedge funds and arbitrageurs, invest over much shorter time horizons . . . and they accordingly favor a short-term spike in the share price over long-term wealth creation.").

266. *See* Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 68 (2003) ("[S]hareholders are a diverse and ever-shifting group of people and institutions, with differing interests and, in the case of institutional investors, differing obligations to their own diverse constituencies."); *see also* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 468–72 (1991) (discussing institutional investor conflicts of interest).

267. *See* Lipton & Rosenblum, *supra* note 266, at 78–79 ("Shareholders with 'social causes' regularly use governance as a mean to promote those causes."); *cf.* Anabtawi, *supra* note 104, at 577–93 (discussing divergent shareholder interests).

268. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 723–24 (2007) (addressing the risks associated with shareholders' short-term biases).

269. *Id.* at 720–22 (discussing the effect of shareholders' pursuit of special interests).

Yet even Lipton and Bebchuck disagree about how shareholder wealth is affected by disparate shareholder interests. Lipton contends that self-interested shareholders encourage companies to prefer short-term earnings increases to long-term value creation.[270] Bebchuk offers a different view. He does not dispute the risk of short-term shareholders negatively influencing companies and incentivizing directors to prefer short-term earnings increases,[271] but contends that differences between shareholders' economic interests do not cause negative wealth effects, and that a company's adoption of shareholder-preferred measures is value-enhancing.[272] Moreover, he argues that the greatest risk to shareholder wealth is not short-term-biased shareholders' influence on management, but the risk that inadequately monitored directors will fail to effectively pursue long-term wealth creation.[273]

Ultimately, Bebchuk and Lipton disagree about how the law should treat hostile takeovers in order to optimize shareholder wealth. Lipton favors the current regime. Since courts essentially defer to boards that reject hostile bids, directors are largely insulated from shareholder influence.[274] But in Bebchuk's view, the choice should belong to shareholders because "[they] have the best incentives."[275] Indeed, Bebchuk argues that companies defeating premium tender offers fail to

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270. *See* Lipton & Savitt, *supra* note 265, at 733 ("[T]ransfer[ing] the basic responsibility of corporate management from directors to shareholders . . . would leave management and directors subservient to [their] whims . . . no matter how . . . self-serving . . . parochial . . . inconsistent with long-term corporate performance, and . . . destructive to the economy as a whole.").

271. *See* Bebchuk, *supra* note 268, at 723 ("The strongest objection to election reform comes from concerns about short-termism. The fear of being replaced, it might be argued, could lead boards seeking to please shareholders to take actions that improve short-term results but are not optimal from a long-term perspective."); *accord* Lipton & Savitt, *supra* note 265.

272. *See* Bebchuk, *supra* note 268, at 721 ("The only resolutions that systematically obtain majority support are those calling for changes that are viewed as value-enhancing by a wide range of financial institutions – such as destaggering the board or rescinding poison pills. In contrast, proposals that focus on social or special-interest issues uniformly fall far short of a majority.").

273. *See id.* at 724 ("Thus, the short-termism concern might justify providing boards with periods of significant length during which they do not face a meaningful chance of ouster. . . . While short-term insulation might induce directors to focus on long-term performance, indefinite insulation would enable boards to deviate from focusing on shareholder interests in both the short run and the long run.").

274. *See* Edelman & Thomas, *supra* note 262.

275. Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Transactions*, 69 U. CHI. L. REV. 973, 1004 (2002).

produce worthwhile long-term returns.[276] Thus, he favors weakening takeover defenses and expanding shareholder power in two ways: governance reforms incentivizing directors to advance shareholder interests[277] and limiting directors' takeover obligations to providing shareholders adequate information to make an informed decision.[278]

However, there is reason to doubt Bebchuk's claim that shareholders would be better off if they were permitted to vote in favor of hostile takeover bids. At first, shareholders may benefit. A more takeover-friendly legal regime presumably increases takeover attempts and successes. Relaxing takeover restrictions also should, at first, increase the likelihood that activist strategies result in takeovers. Even though activists typically hold small interests in target companies,[279] constraining board influence should improve takeover prospects despite activists' low voting power. Perceiving greater certainty in takeover consummation, merger arbitrageurs should contribute to this effect by investing in takeovers in greater numbers.[280] Activism could also become a greater determinant in other shareholders' returns because of its higher incidences of success. While there is only mixed evidence that activism benefits shareholders generally[281]—and it increases return

276. Lucian Bebchuk, Op-Ed., *An Antidote for the Corporate Poison Pill*, WALL ST. J., Feb. 24, 2011, http://online.wsj.com/article/SB10001424052748704476604576158211261083194.html ("[T]he empirical evidence indicates that when directors use their power to block offers, it often proves detrimental to shareholder interests. . . . [B]oards that defeated premium offers failed on average, even in the long run, to produce returns for their shareholders that made remaining independent worthwhile."); *see also* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 551 ("Defeat of a hostile bid is, on average, bad for the target's shareholders . . . . [If] targets that remain independent have hidden value on their own, there is no evidence of this over the two or three year period that the available studies cover.").

277. Bebchuk, *supra* note 268, at 729 ("[P]reventing incumbents from blocking hostile offers" and "facilitat[ing] removal of directors by shareholders via the ballot box" are complementary policies that "reinforce each other and both operate to make boards more accountable and more attentive to shareholder interests."); *see also* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 409 (2005) (concluding that "staggered boards are associated with an economically meaningful reduction in firm value").

278. *See* Bebchuk, *supra* note 275, at 1001–02.

279. *See supra* note 85 and accompanying text.

280. *See supra* note 139 and accompanying text.

281. *See supra* Part IV.A.

volatility[282]—activist strategies resulting in takeovers positively affect shareholder wealth.[283] Thus, increasing the likelihood of takeover successes should have initial positive effects on shareholder wealth.

However, Hedge Funds employ a multitude of strategies and are generally sufficiently flexible to be able to allocate funds into emerging opportunities.[284] Because of this feature, any increased activist strategy returns could simply attract new capital into the strategy in search of increased expected return, bringing about a new risk and return equilibrium that ultimately lowers expected returns. The ultimate consequences for shareholders' economic interests cannot be precisely quantified beyond these broad strokes. And it cannot be said with any certainty, as Bebchuk contends, that weakening takeover defenses will generate positive aggregate shareholder wealth effects given the uncertain relationship between shareholders' economic interests.[285]

There is also reason to heed Lipton's warning that empowering shareholders will distort economic returns and destroy long-term value.[286] A more relaxed takeover regime may exacerbate existing intra-shareholder conflicts among all holders of stock.[287] Both Hedge Funds and Institutions sometimes advance their economic interests while negatively affecting other shareholders, such as retail investors, holder of beneficial interests of Institutional Investors, and any other holders of stock.[288] This concern is particularly acute when we consider the case of Hedge Funds, which have the ability to create unique exposures that often create economic interests that are diametrically opposed to those of diverse, unaffiliated shareholders and can be opposed to Institutional Investors interests, and the interests of their beneficiaries.[289] A more relaxed takeover regime may also exacerbate Hedge Funds' and Institutions' short-term biases and negatively affect retail investors, the holders of beneficial interests of Institutional Investors and any other holders of stock.[290] Ultimately, both shareholder conflict and short-term

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282. *See supra* notes 94–96 and accompanying text; *supra* Part IV.A.
283. *See supra* note 94. *But see supra* Part IV.A., discussing increased volatility resulting from activist strategies.
284. *See supra* note 54. *See generally supra* Part II, describing Hedge Funds and their investment strategies.
285. *See supra* Part IV.
286. *See supra* note 270 and accompanying text.
287. *See generally supra* Part IV.E., describing intra-shareholder conflicts.
288. *See generally supra* Part IV.E.
289. *See supra* notes 107–22 and accompanying text.
290. *See generally supra* Parts IV.C–D.

bias considerations weigh against the case for empowering shareholders as a group to decide their fates in the context of mergers because of the outsized influence of Hedge Funds and Institutional Investors.

B. THE *AIRGAS* COURT REACHED THE RIGHT CONCLUSION

Delaware courts have expressed skepticism at the idea that shareholders' short-term preferences might outweigh their interests in long-term value: in *Airgas*,[291] the court wondered whether there was sufficient evidence to suggest that Airgas stockholders were so motivated by short-term considerations to "'take a smaller harvest in the swelter of August over a larger one in Indian Summer?"[292] In *Mercier v. Inter-Tel*,[293] Vice Chancellor Strine similarly expressed skepticism that Hedge Funds would accept a lower price in a merger transaction than they believed the company to be worth in the proposed alternative transactions.[294] Strine noted his reluctance to grant an injunction based on there being "good" shareholders and "bad short-term" shareholders.[295] Despite the Chancery Court's doubts that shareholders have disparate economic incentives, in each case,[296] the court held that the target board's actions satisfied *Unocal*'s enhanced standard.[297]

Furthermore, since *Unocal* jurisprudence permits board decision-making premised upon shareholders' variable economic incentives, Delaware's takeover regime is thus aligned with empirical evidence

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291. 16 A.3d 48 (Del. Ch. 2011).

292. *Id.* at 111 (quoting Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 815 (Del. Ch. 2007)).

293. 929 A.2d 786 (Del. Ch. 2007).

294. *See id.* at 815 ("Buttressing an injunction on the notion that these investors would take a smaller harvest in the swelter of August over a larger one in Indian Summer is not something this record supports. Sophisticated short-term traders can reap profits from a variety of scenarios.").

295. *Id.* at 814.

296. In *Mercier*, the court held that the target board acted reasonably and in good faith to maximize value for the shareholders, *id.* at 819, when the board changed the record date for an upcoming merger vote, in part to encourage merger arbitrageur purchases. The action was not disproportionate or coercive because shareholders could still vote no. *Id.* at 816.

297. This result is not surprising. *Unocal*'s first prong is a deferential reasonableness test, *see supra* notes 8–10 and accompanying text, and a board's reliance on a less than certain premise, without more, is insufficient for the first part of the test not to be satisfied.

demonstrating that not all shareholders are motivated by capturing long-term value.[298] For example, merger arbitrageurs exhibit extremely strong short-term biases as the strategy eschews long-term value by design.[299] Activist Hedge Funds also show mixed effects of short-term biases.[300] Even Institutions exhibit short-term preferences.[301] Most importantly, both risk-averse merger arbitrage[302] and risk-heavy activist strategies[303] are incentivized to vote in favor of mergers and lock in gains.

Thus, the *Airgas* court's decision to approve maintenance of the poison pill in light of the threat posed by short-term investors to other shareholders' interests[304] reflects empirical data about shareholders' preferences and incentives, and preserves a target board's capacity to act upon this data.[305] Furthermore, preserving the formidable anti-takeover effect of existing *Unocal* jurisprudence is supported by these same empirical considerations and any potentially negative consequences of relaxing takeover defenses.[306]

CONCLUSION

This Note establishes that Hedge Funds and Institutional Investors generally have different preferences and incentives in takeovers. Consequently, this Note concludes that the *Airgas* court correctly determined that *Unocal* permits a target board to maintain their poison pill to protect certain shareholders whose economic interests are threatened by Hedge Funds tendering into potentially inadequate bids.

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298. *See supra* Parts II, III, and IV.
299. *See supra* notes 130–31, 133–34, 239 and accompanying text.
300. *See supra* notes 241–43 and accompanying text.
301. *See supra* notes 237–38 and accompanying text.
302. *See supra* notes 130–31, 133–42 and accompanying text.
303. *See supra* notes 94–96 and accompanying text.
304. *See Airgas*, 16 A.3d at 111–12.
305. *See generally supra* Parts IV.A–E.
306. *See, e.g.*, *supra* Part V.A., discussing potential unintended consequences resulting from relaxing takeover defenses.