



# Journal of Business

Volume 03, Issue 01, 2019: 01-12

Article Received: 05-11-2018

Accepted: 16-01-2019

Available Online: 30-01-2019

ISSN 2380-4041(Print), ISSN 2380-405X(Online)

DOI: <http://dx.doi.org/10.18533/job.v3i1.108>

## Hedge Fund Activism and Corporate Life Stage: Case Studies of High-technology Companies

Sixiao Xu<sup>1</sup>

### ABSTRACT

Hedge fund activism refers to hedge funds' attempt to change how the company is operated. Hedge fund activism can improve the governance of target companies. But it might also be myopic and increase short-term returns by reducing corporate value in the long term. This paper argues that the real effect of hedge fund activism depends on specific characteristics of target companies and examines one of such factors, corporate life stage. By conducting case studies on hedge fund activism at Apple, eBay and HP, it shows that companies at later life stages are less vulnerable to myopic hedge fund activism, have more corporate governance concerns and thus are more likely to benefit from hedge fund activism.

**Keywords:** Agency Costs, Corporate Life Stage, Hedge Fund Activism, Short-Termism.

**JEL Classification:** G34, K22, O31.

This is an open access article under [Creative Commons Attribution 4.0 License](https://creativecommons.org/licenses/by/4.0/).

Hedge fund activism refers to the attempt of hedge funds, as non-controlling shareholders, to change how the company is operated. Frequently used techniques include publicly challenging the management, submitting shareholder proposals and launching proxy fights. The corporate world has seen a surge of hedge fund activism since 2000. High profile cases include Icahn's activism at Time Warner (The Economist, 2006), Trian's activism at Heinz (Benoit, 2015) and Starboard's activism at Macy's (Roumeliotis and Flaherty, 2017). This has sparked an academic debate on whether hedge fund activism is beneficial or detrimental to target companies, the result of which remains unclear. One major problem with existing literature is that although it realized how different types of activism could have different effect, it ignored how the same activism tactic can have different effect on companies with different characteristics. Meanwhile, regulatory response to the rise of hedge fund activism was more one-sided. Most reform proposals sought to discourage hedge fund activism. But if the effect of hedge fund activism depends on firm specific factors, broad brush legal rules cannot regulate effectively.

This paper seeks to fill the gap in existing literature and throw new light on legal reform by examining one firm specific factor, corporate life stage. Case studies on activism campaigns at Apple, eBay and HP provide tentative support to the hypothesis that hedge fund activism is more likely to be beneficial to mature companies, companies with divisions at different life stages and declining companies. Thus this paper argues that instead of developing rigid legal rules, legal reform should focus on giving other shareholders more incentive to evaluate hedge fund activism based on firm specific factors.

The paper is structured as follows. Section 1 outlines the advantages and disadvantages of hedge fund activism as well as empirical evidence on the efficiency of hedge fund activism. Section 2 introduces this paper's

<sup>1</sup> University of Warwick, 28-34 Corporation Street, Coventry, CV1 1GF, UK. E-mail: S.Xu.3@warwick.ac.uk Phone: 07940076385

research methodologies. Section 3 describes companies' life cycle. Section 4 examines Greenlight Capital's activism at Apple and how hedge fund activism can be beneficial for mature companies. Section 5 studies Icahn Enterprise's activism at eBay and how hedge fund activism can be efficient to conglomerates. Section 6 analyzes Relational Investors's activism at HP and how hedge fund activism facilitates turnarounds. Section 7 highlights policy implications.

## 1. Advantages and disadvantages of hedge fund activism

The growth of hedge fund activism has ignited a lively debate on whether it is good or bad for target companies. Over the years several advantages and disadvantages of hedge fund activism have been identified. This section briefly outlines them and also evaluates empirical studies on the efficiency of hedge fund activism.

### 1.1 Advantages

The main advantage of hedge fund activism lies in its improvement to the corporate governance system. In the US and the UK where share ownership is dispersed, control of the company is being exercised by managers who are managing directors and executive officers (Berle and Means, 1932). Managers are agents of the company and should maximize corporate value. However, they also have incentives to act self-interestedly because they can fully capture the benefits of doing so and impose the costs to the company. Thus one major task of corporate governance in the US and the UK is to control the agency problem (Jensen and Meckling, 1976). Three mechanisms are in place to perform this role, namely board monitoring, incentive alignment and market discipline, none of which are fully effective.

The board of directors, especially independent directors who have no relationship with the company other than attending board meetings, should monitor managers (NYSE Listed Company Manual, 2009). Board monitoring is not perfectly effective because independent directors are not really independent from managers. For example, although in listed companies the hiring of directors and their remuneration are decided by independent committees, in most circumstances these committees only choose from a list of options prepared by personnel who answer to the management (Jensen and Murphy, 2004). Hence the subjects of monitoring still have significant influence on their supervisors. Independent directors are also likely to be more sympathetic towards managers than shareholders, as many independent directors are managers or retired managers of other companies (Sharpe, 2011). A board dominated by directors who share the same background and the same mindset has group-thinking problems which make voicing different opinions difficult. The absence of dissidence is likely to make the board overly confident and reach polarized decisions (O'Connor, 2003). More importantly, the board has an advisory function as well as a monitoring function. Advising on strategies requires deep specific knowledge of the company, which is unlikely to be possessed by independent directors. For the advising role to be performed effectively, managers must trust the board enough to divulge key information and be receptive to advice. Pressure from intensive board monitoring would prevent this from happening. Thus there is a tradeoff between the board's monitoring and advisory function (Boot and Macey, 2004) and some companies, such as high-technology companies, would prefer the latter over the former.

By linking managers' remuneration to corporate performance or by paying managers in the form of shares and other securities derivatives, companies can align managerial interests with theirs, which induces managers to control agency costs voluntarily (Jensen and Meckling, 1976). However, managerial remuneration packages are designed by board committees. Companies with ineffective boards are likely to have insufficient incentive alignment. On the other hand, excessive performance-based remuneration gives managers incentive to manipulate corporate performance (Bebchuk and Fried, 2010). For example, a manager with a large amount of shares to sell might drive up the share price by moving next quarter's earnings to this quarter. Incentive alignment has other costs as well. Managers have invested most of their human capital into the company. Their inability to diversify makes them risk-averse. Hence they would value performance-based remuneration, which has a level of risk as some factors affecting corporate performance are outside their control, less than fixed payments of the same expected amount (Jensen and Murphy, 2004). The discount would be larger for companies with higher levels of risk, which is why most of these companies shy away from performance-based remuneration.

The equity market is supposed to reflect a company's value in its share price. Companies with high agency costs and thus low share price would be taken over and their managers removed by companies which believe that they can create the highest value from the targets' assets (Manne, 1965). Market discipline is only effective when the share price is able to promptly reflect non-public information, such as managerial behavior, or in other words, when the market is strongly efficient.<sup>2</sup> In a strongly efficient market, corporate insiders would not be able to make abnormal returns by trading on non-public information. As this is clearly not the case, the market is only relatively efficient (Wachter, 2003). As to the discipline of the market for corporate control, high takeover costs make potential acquirers more conservative. Instead of simply taking over every company where they believe they can create more value, potential acquirers require more reasons for takeovers, such as synergies between the target

<sup>2</sup> The market is efficient in the weak form if a company's share price reflects past information, in the semi-strong form if it reflects public information and in the strong form if it reflects non-public information (Fama, 1970).

and their existing business. Often companies with the most serious companies are left independent (Coffee, 1984). The discipline of the market for corporate control is further limited in the US where takeover defences are permitted (Unocal v. Mesa Petroleum, 1985; Paramount Communications v. Time, 1989)

Hedge fund activism can improve the effectiveness of other corporate governance mechanisms. By publicly challenging the company's strategies or its managers' capabilities, hedge fund activism forces independent directors who are otherwise biased towards managers to reevaluate the company's situation more objectively. The backing of hedge funds also makes challenging powerful managers easier for independent directors. Representatives of hedge funds are often included into corporate boards as a result of activism campaigns.<sup>3</sup> They increase board diversity and mitigate the group-thinking problem. Hedge fund activism to increase managerial remuneration's sensitivity to corporate performance (Brav, Jiang, Partnoy and Thomas, 2008) and to dismantle takeover defences (Greenwood and Schor, 2009) also improves the effectiveness of incentive alignment and market discipline.

More importantly, hedge fund activism as an independent corporate governance mechanism fills the gaps between internal and external governance. The agency problem is first controlled internally by incentive alignment, then by board monitoring. A strongly efficient market would promptly reflect the company's agency costs resulting from internal governance failure. If the company does not improve its internal governance, its share price would be further discounted up to a point where the market for corporate control is invoked as a governance mechanism of last resort (Weir, 2013). Since the market is relatively efficient, a company's share price is only able to reflect the agency problem when it is quite serious and when internal governance has failed massively. Thus a governance gap exists when the company has some level of agency problem but it is not serious enough to depress its market price (Coffee, 1984). Hostile takeovers discipline by changing control of target companies. The high costs to do so leave many companies undisciplined and another gap in the corporate governance system (Coffee, 1984).

To search for potential targets, hedge funds conduct deep analysis on a large number of companies. Securities analysts who are major market formers also perform this task. But they might refrain from issuing negative opinion on a company to keep being in its favor, which gives them access to valuable information (Coffee, 2003). Hedge funds do not have such concerns and are likely to act on problematic companies before their problems are reflected in the share price. Addressing problems at an earlier stage also means that they would do less harm to the company and can be fixed more easily, filling the first gap in corporate governance. Moreover, hedge funds engage in activism by purchasing minority shareholdings. Compared to the market for corporate control, the market of hedge fund activism is characterized as a market for corporate influence (Cheffins and Armour, 2009), which is not only cheaper, but also less risky. Hence hedge fund activism is able to discipline companies which are left unaddressed by the market for corporate control, filling the second gap in corporate governance.

## 1.2 Disadvantages

Generally there are two problems with hedge fund activism. First, hedge funds have incentive to engage in self-interested activism when their private benefits from activism outweigh the sum of their loss as shareholders and activism costs. For example, hedge funds often bet against a company by short selling, that is selling borrowed shares with a view to buy them back later (Martin and Partnoy, 2005). Hedge funds with large short positions might purchase into the company to depress its price. On the other hand, a hedge fund might bet for a company's share price to go up by holding call options, which give it the right to purchase a certain amount of shares at a pre-specified price in a certain period of time. Since the bigger the difference between the market price and the exercise price is, the more profitable it is for the hedge fund, the hedge fund has incentive to engage in activism to pursue strategies which are beyond common shareholders' risk tolerance (Martin and Partnoy, 2005).

Second, hedge fund activism might be myopic. Hedge funds often exit shortly after their activism is concluded. As hedge funds do not bear the costs of their actions in the long term, they have incentive to increase the company's current worth by damaging its long-term value (Bebchuk, Brav and Jiang, 2015). Moreover, hedge fund managers' remuneration is heavily performance-based. Fund managers get nothing if they fail to meet that year's performance targets. But fund managers who beat the targets are commonly paid twenty percent or more of the funds' profits (Kahan and Rock, 2007). This pay structure gives fund managers incentive to engage in short-term activism, especially at the end of each year. More importantly, it is argued that hedge fund activism creates a systematic short-term bias. As companies fear that their current under-performance would invite hedge fund activism, they focus excessively on the short term and refrain from long-term investments, such as research and development (Coffee and Palia, 2016). The image of hedge funds as short-term traders is so strong that makes short-termism a strong argument against hedge fund activism. But this problem is sometimes exaggerated. Consider the premise of the myopic argument, that hedge funds must be able to exit the company before negative

---

<sup>3</sup> See the HP case for an example. Other examples include Icahn Enterprise's activism at Yahoo and Starboard Value's activism at Darden.

consequences of their activism manifest. As investors who take on the shares would bear the consequences, they would not purchase the shares if they believe that the activism is detrimental in the long term (Bebchuk, 2013). They are also likely to recognize myopic strategies, as the most likely buyers of hedge funds' large positions are professional institutional investors.

### 1.3 Empirical evidence

A large number of empirical studies have been conducted to examine hedge fund activism's effect on corporate value. Almost all studies found that target companies made above-market stock returns in the short term around hedge fund activism. For example, Brav *et al* found that target companies made 8.4% positive cumulative abnormal returns in a [-20, +20] window (Brav, Jiang, Partnoy and Thomas, 2008). This at least showed that hedge funds did not engage in self-interested activism. Most empirical studies also found positive abnormal stock returns in the long term after hedge fund activism (Bebchuk, Brav, and Jiang, 2015). But due to their methodological problems, their findings failed to undermine the myopia argument.

The first problem is causation. A common issue faced by researchers is how to make sure that hedge funds really caused operation or performance changes, instead of simply investing in companies which were about to have these changes even without activism. Most researchers addressed this problem by focusing only on hostile activism cases. The rationale is that companies which resisted hedge fund activism would not adopt the changes it advocated voluntarily or experience performance improvement absent hedge fund activism (Brav, Jiang, Partnoy and Thomas, 2008). However, companies which were unresponsive to shareholder demands were often companies with high agency costs. Studies focusing only on these companies might overestimate the overall beneficial effect of hedge fund activism.

Another problem with causation is how to ensure that the changes were caused by hedge fund activism, not other external factors. To address this problem, most researchers compared the performance of target companies and control companies, often matched by size, industry and past performance. But there is always the possibility that some important factors were left in the matching process. In fact, if the researchers managed to construct a perfectly matched control group, then the question raised would be why the control companies were not targeted in the first place (Gillian and Starks, 2007). Moreover, as target companies and control companies are often competitors, target companies' improved performance might have negative effect on the performance of control companies. Comparing the two groups' performance would overestimate the benefits of hedge fund activism. On the other hand, target companies' improved performance might tempt control companies to adopt the changes advocated by hedge funds voluntarily (Gantchw, Gredil, and Jotikasthira, 2018). Comparing the two groups' performance would then underestimate the benefits of hedge fund activism.

Even if the empirical studies were flawless individually, their discrepancy means that they cannot be collectivized into a piece of strong evidence supporting hedge fund activism. First, most studies define long term differently. For example, Klein and Zur examined target companies' stock performance one year after the announcement of activism (Klein and Zur, 2009). This period is likely to be too short even for activism to be concluded. In contrast, Bebchuk *et al* examined target companies' stock performance five years after activism. Although five years is definitely a long term, many events had happened in this period, making establishing causation particularly difficult.

More importantly, although most studies agreed that hedge fund activism created long-term corporate value, they could not agree on how value was created. Many empirical studies examined whether value was created from improved operating performance and reached different conclusions. For example, Boyson and Mooradian found that one year after hedge activism, ROA<sup>4</sup> of target companies was improved by 6% (Boyson and Mooradian, 2011). Meanwhile, Klein and Zur found that ROA was 2.4% lower (Klein and Zur, 2009). One explanation for this inconclusiveness lies exactly in their focus on ROA. Increased ROA is not an accurate proxy for improved operating performance, as this ratio can be increased with reduced earnings but even larger reduction in assets (Clifford, 2008). Improved corporate governance might lead to increased corporate value without changing operating performance. But few empirical studies considered this possibility.

Another problem with existing empirical studies is that although they examined how different types of hedge fund activism had different effect, they have not considered how the same activism strategy can have different impact on companies with different characteristics. This paper seeks to fill the gap by examining one of these factors, the life stage of target companies.

## 2. Methodology

This paper conducts case studies on hedge fund activism in three high technology companies, Apple, eBay and Hewlett-Packard. Case study is chosen as the main methodology because hedge fund activism is a real life phenomenon. Some factors, which might determine the outcome of hedge fund activism, cannot be captured by abstract theoretical or empirical research. By examining hedge fund activism in context, case studies can identify what these factors are and how they interact (Baxter and Jack, 2008). One drawback of case studies is that the

---

<sup>4</sup> Return on Assets

findings are based on specific contexts and might not be generalized to other cases (Flyvbjerg, 2013). Moreover, cases in this paper are also selected based on whether there is sufficient information, such as SEC filings and analyst reports, and more importantly, whether there are arguments from both hedge funds and target companies. This approach inevitably biases towards large listed companies and confrontational activism. Due to these problems, this paper only seeks to propose hypotheses and provide tentative support to them.

With regard to case selection, this paper focuses on high-technology companies because both the advantages and disadvantages of hedge fund activism have strong effect there. Innovation is important to high-technology companies. To be able to innovate, a company's decision-makers must have profound knowledge of the company and in the relevant business field, which is why most high-technology companies have a majority of inside directors (Baysinger, Kosnik and Turk, 1991). Innovation requires long-term investment and has a high level of risk. Hence to encourage innovation, managers must be reassured that they would not be removed or paid based on the company's performance in the short term. To insulate their managers from short-term pressure, many high-technology companies have multiple classes of shares. For example, while most public shareholders of Facebook hold ordinary or non-voting shares, the CEO Mark Zuckerberg holds super-voting shares which allow him to exercise 56.9% of the company's voting rights (Pramuk, 2016). Thus it can be said that innovative companies often sacrifice corporate governance for innovation. But this does not mean that corporate governance is unnecessary. In fact the agency problem is more serious a concern for innovative companies than for low-technology companies. As information asymmetry is more severe in innovative companies, monitoring is more difficult (Holmstrom, 1989). This, combined with manager's high level of control, allow them to create larger agency costs. Hence hedge fund activism might be more valuable to innovative companies than low-technology companies. However, as innovative companies' success depends on their innovative capacity, short-term hedge fund activism might also do more harm to innovative companies than to low-technology companies.

### 3. Corporate life stages and corporate governance

Generally there are four stages in a company's life cycle. At the startup stage, the company is developing a new product. This new product could also be a new type of service or a new way to produce or sell existing products. Once the company has a preliminary product, it proceeds to create a market for the product and enters into the growing stage with rising demand for the product (Levitt, 1965). During this course of growth, the company improves and finalizes the product as well as the production process. Competitors also enter into the market at this stage. The scale and time of new entry depends on the availability of production resources and substitute products (Levitt, 1965). For example, once a brand introduces a new fashion style, other brands are able to follow quickly by offering similar designs. Meanwhile, imitation is much more difficult in the pharmaceutical industry where most initial producers have patents on the technologies used. When competition appears, initial producers are more likely to be outcompeted by new entrants because they have spent more resources in product development and have to charge higher prices to recover costs (Levitt, 1965). For these initial producers, although the demand for the product is rising, their market share is shrinking and they enter into the decline stage. For other companies, eventually the demand for the product and their market share stabilize and they enter into the mature stage. They enter into the decline stage when the demand for the product declines. This usually happens when a superior product is produced. Many companies are liquidated while others are successfully turned around and return back to earlier stages.

At the beginning of a company's life, it is being controlled by a few entrepreneurs who have contributed their personal wealth to the company. The company might also have bank loans, but most banks are passive at this early stage. If the development goes well, the company might be able to secure investments from business angels and venture capital funds. These investors take large shareholdings and constantly monitor the company, resulting in a young company having minimal separation of ownership and control (Toms, 2013). As the company grows, the amount of capital it needs can no longer be secured in the private market and the company has to offer its shares to public shareholders. The initial public offering is a turning point where some venture capitals exit the company. The positions of remaining shareholders and entrepreneurs are diluted by newly issued shares. In the US and the UK where most investors choose not to take large positions, the company's share ownership becomes dispersed and loses control (Toms, 2013). Meanwhile, as the company grows, its objective expands significantly, from product development to tasks such as marketing, investing and relationship building with suppliers, distributors and competitors. Managing also becomes more demanding as the company grows and has more employees. Gradually these tasks fall outside the scope of entrepreneurs who are mostly technological experts. Hence professional managers are brought in (Zahra and Hayton, 2005). The introduction of highly specialized managers results in managerial responsibilities, which used to be shared by a few entrepreneurs being defined and allocated formally. As control of the company is exercised by managers who have small shareholdings, the separation of ownership and control and the consequent agency problem become serious concerns (Toms, 2013). Therefore, companies at later life stages have greater need for corporate governance and are more likely to benefit from hedge fund activism. Greenlight Capital's activism campaign at Apple supports this point.

### 4. Apple: Corporate life stages and cash reserves

#### 4.1 Facts

In May 2012, Greenlight Capital (hereafter referred to as Greenlight), a New York based hedge fund, sent a public letter to Apple, asking it to reduce its \$137 billion cash reserves by issuing preferred shares. Apple's refusal was clearly shown in Proposal 2 of its proxy card for 2013, part of which asked shareholder approval to eliminate the board's power to unilaterally issue preferred shares (APPLE INC, 2013b). In a shareholder conference in February 2013, Greenlight outlined its plan and urged shareholders to support it by voting against Apple's proposal.

Greenlight suggested Apple award one common share with five iPrefs. iPrefs would be listed perpetual preferred shares with no maturity date. They would have a face value of \$50 and a quarterly yield of \$0.50 (Greenlight Capital, 2013). Upon Apple's liquidation, holders of iPrefs would be paid before common shareholders. According to Greenlight, iPrefs would have two advantages. First, Apple would reduce its cash reserves by paying dividends of iPrefs. Total payments would be around \$10 billion annually. Compared to more traditional ways to reduce cash reserves, such as by paying one-time dividends or buying back shares, this way of reduction is more gradual and would most protect Apple's financial flexibility (Greenlight Capital, 2013). Second, as iPrefs would be publicly traded, they would attract investors who are more risk-averse, moving the company's price closer to its real value (Greenlight Capital, 2013).

Despite all the advantages argued by Greenlight, it appeared that Proposal 2 was likely to pass. To prevent this from happening, Greenlight sued Apple on the grounds that Proposal 2 violated Section 14e of the Securities and Exchange Act 1934 by bundling several proposals into one, which denied shareholders the right to vote on each separate issue. Greenlight also sought preliminary injunction to enjoin Apple from certifying proxies which had been granted to it and proceeding with the general meeting (Greenlight Capital LP v Apple Inc, 2013). For preliminary injunctions to be granted, the parties seeking the relief must demonstrate that they are likely to succeed on the merits of the case, that they are likely to suffer from irreparable harm if the relief is not granted, that the balance of harm tips to their favor and that granting the injunction is in the public interest. (Greenlight Capital LP v Apple Inc, 2013)

The proposal in question asked shareholder approval to amend the company's articles of association on four matters, namely to adopt majority voting for director elections, to remove the board's power to issue preferred shares without shareholder approval, to establish par value for its shares and to eliminate sections on preferred shares from its articles of association (APPLE INC, 2013b). Apple argued that they were not separate matters because they all concerned the amendment of articles (Greenlight Capital LP v Apple Inc, 2013). Apple further argued that all four matters were ministerial or technical, which qualified the exception to Section 14e. For example, the board's blank check power to issue preferred shares is nonmaterial because the board had never and would never issue preferred shares without shareholder approval (Greenlight Capital LP v Apple Inc, 2013). Both arguments were unsatisfactory to the court. The court ruled that if Apple's practice was allowed, Section 14e would only be applicable to the most egregious cases of bundling (Greenlight Capital LP v Apple Inc, 2013). As to the materiality of the matters, the judgment should be made by shareholders, not the board (Greenlight Capital LP v Apple Inc, 2013). Thus Greenlight succeeded in showing a more than fifty percent probability of success. Apple argued that shareholders would suffer no harm from the proposal as they could always amend the articles. This argument was also not accepted by the court. According to the court, the harm lay in shareholders being forced to cast votes unrepresentative of their view (Greenlight Capital LP v Apple Inc, 2013). Hence Greenlight would suffer irreparable harm without the injunction. As the balance of harm tipped in Greenlight's favor and granting the injunction was in the public interest, the court granted Greenlight the injunction it sought (Greenlight Capital LP v Apple Inc, 2013). Afterwards Apple withdrew Proposal 2 from its proxy card. It then announced a plan to return \$100 billion of its cash reserves to shareholders. Quarterly dividend was increased by 15%. In May, Apple issued \$17 billion worth of notes to its shareholders. It used the remaining \$60 billion in a share repurchase plan which was completed in 2015 (APPLE INC, 2013a).

Hedge fund activism to reduce cash reserves has often been criticized as myopic. Greenlight's activism would be especially detrimental given the large scale of the reduction in cash, the importance of innovation to Apple and the highly confrontational nature of the campaign. However, there has been no observable evidence that Greenlight's activism destroyed Apple's value in anyway. The reason behind this phenomenon is likely to lie in Apple's life stage.

#### 4.2 Analysis

It is often argued that companies with small or no cash reserves are unable to seize business opportunities when they arise or to absorb unanticipated negative shocks (Lipton, 2013). This argument is more valid for young companies. Young companies need large amounts of capital to develop products and to fuel growth. Raising capital in the market is expensive for them because they are unfamiliar to the market and must convince the market to invest, which, due to their lack of record, might be difficult. Moreover, young companies have high levels of risk because they are experimenting with their products and strategies. Some of these attempts inevitably fail. It is also because they operate in a market which is still forming and full of changes. As investors generally require risk

premiums to invest in risky companies, raising capital in the market can be costly for young companies (Graham, 2000). Raising capital externally is also slow. As they must be able to respond promptly to changes, retaining earnings become paramount for young companies. Thus hedge fund activism to reduce their cash reserves simply to have more payouts is more likely to transfer long-term value to the short term and be myopic.

The situation is quite different for mature companies, such as Apple. Apple has multiple product lines. Products such as iPhones, iPads, Macs and iTunes are finalized. Although Apple constantly introduces new versions, the core features of these products remain unchanged, as well their production process and retail systems. Also unchanged is the demand for the products. For example, sale of iPads in 2013 accounted for 19% of Apple's total sale. The percentage was 20% in 2012 and 18% in 2011 (APPLE INC, 2013a). Thus these products are mature products with low levels of risk. Apple is also developing new products, which is risky. However, because Apple's mature products are extremely successful, their large profits make any loss from failed new product development insignificant. For example, in 2013 Apple invested \$4.5 billion in research and development (APPLE INC, 2013a). If a company making \$10 billion annually invests this amount in innovation, it will have a high level of risk. But Apple made \$53.76 billion from selling its mature products in 2013 (APPLE INC, 2013a). Even a catastrophic failure in innovation is unlikely to significantly alter Apple's risk level. Therefore, Apple is a mature company with stable cash flows. Statistic also supports this observation. Apple made \$53.76 billion from operating activities in 2013 and \$50.9 billion in 2012. Operating expenses remained at 9% of total net sales (APPLE INC, 2013a). As mature companies have low levels of risk, they should be able to predict quite accurately how much cash they need. Raising capital in the market is also much cheaper for them than for young companies. Thus there is no need for mature companies to heavily retain earnings. In fact, large cash reserves at mature companies might be the result of agency problems. To avoid being punished by high capital costs, managers with high agency costs might reserve cash to insulate themselves from market discipline (Jensen, 1986). Therefore hedge fund activism to reduce cash reserves is more likely to be beneficial for mature companies.

## 5. EBay: Corporate life stage and conglomerates

### 5.1 Facts

In 2014, Icahn Enterprise (hereafter referred to as Icahn), a hedge fund in New York, launched a proxy fight at eBay to nominate two directors and to spin off PayPal, eBay's online payment division. Icahn outlined its rationale in its public letters to eBay's shareholders. It accused the two directors it intended to replace, Scott Cook and Marc Andreessen, of having conflicts of interest, especially Andreessen who managed venture capital Andreessen Horowitz. Andreessen served on several corporate boards, including eBay's competitor Silver Lake, which purchased Skype, a video chatting software, from eBay in 2009. Icahn considered the fact that Silver Lake was able to purchase Skype for \$2.75 billion and sold it to Microsoft for \$8.5 billion shortly afterwards evidence that Andreessen's conflicts of interest prevented him from discharging his duties to eBay (Icahn, 2014). Meanwhile, eBay insisted that Andreessen was excused from decision-making on the sale of Skype (eBay, 2014).

Although eBay adamantly refused Icahn's request at first, it eventually reached an agreement with Icahn according to which Icahn aborted the proxy fight. PayPal was spun off later that year. Andreessen also resigned from eBay's board. Whether Icahn was right on Andreessen was unclear. It is not uncommon for venture capitals to remain on their investee companies' boards after they go public. Empirical studies have even found that newly public companies in which venture capitals remained had better corporate governance, in the form of more independent boards and less earnings management, than companies without the presence of venture capitals. They suggest that venture capitals, with their expertise in young companies, continue to be helpful to companies going through the private-to-public transition (Hochberg, 2011). However, this beneficial effect might fade as companies grow, as in the case of eBay, which went public in 1998. Since venture capital funds invest in a large number of companies, their conflicts of interest indeed is a concern, especially when the costs of interlocking directorship can no longer be offset by its benefits. Whether or to what extent the Skype transaction was affected by Andreessen's conflicts of interest cannot be said for certain without further information. But more research is definitely needed to examine the depth and breadth of the problem.

With regard to PayPal, the answer is more certain. On September 30<sup>th</sup> 2014, the day PayPal went public, its price closed at \$40.37, while eBay's closing price was \$28.57. The day before the split, eBay traded at \$66.29, which was less than the summed up price of the two entities (Saha, 2017). This showed that PayPal was undervalued as a part of eBay. Since eBay's share price before the spinoff was inflated by the prospect of PayPal's public offering, the actual undervaluation of PayPal and the value the spinoff unlocked would be even greater.

### 5.2 Analysis

One of the most common goals of hedge fund activism is to break up conglomerates. This is usually done through spinoffs, which is offering the company's shares in its subsidiary to public investors. Other techniques to deconglomerate include selling the subsidiary to another company and carve-outs. In a carve-out transaction, the company offers its shareholders the choice between exchanging their shares for shares of the carved out subsidiary and holding shares in the remaining business (Stowell, 2010). These transactions often result in

significant premia for shareholders. Hedge fund activism to deconglomerate has often been criticized as myopic as in their pursuit of the premiums, hedge funds push for sale of subsidiaries without considering their value to the company. Companies might need to spend more resources to restore the discarded subsidiaries. Some companies are made worse off, attracting hedge funds back to push for more sales, which is why hedge funds are equated to corporate raiders in the 1980s (Denning, 2015).

On the other hand, the costs and benefits of conglomerates have long been recognized. Integration can mitigate the noncontractibility problem (Grossman and Hart, 1986). Suppose a company needs special material for production, which requires its supplier to buy new machines and hire specialized workers. As the material is not needed by other companies, the company can wait until the supplier made the investments to lower its purchase price. If the contract specifies a purchase price, the supplier would have incentive to lower the quality of the material. The company is unable to contract to ensure quality because of its information disadvantage and the cost of contracting. The problem can be addressed by one party, presumably which could make more profits from the production, acquiring control of the other (Grossman and Hart, 1986).

Integration might create synergies, that two entities combined might cost less or generate more income than the sum of their cost or income as independent entities. Generally synergies arise from the sharing of resources. For example, two entities can save costs by sharing storage, communication system or distribution network. Considerable profits can be made by sharing customers, or cross-selling, which refers to one entity selling its customers the products of other entities (Sudarsanam and Broadhurst, 2012). The sharing of knowledge also creates synergies. For example, a manufacturer of metal objects would have better knowledge than the producer of metal on what types of metal the market needs. Meanwhile, the producer knows more about the features of each type of metal and their possible application. Their exchange of knowledge is likely to spark innovation and create significant value. However, synergies must not be overvalued, as some synergies can be replicated with independent entities. For example, universities and enterprises often form strategic alliance to share knowledge, although replication would be more difficult if the information is proprietary or require familiarity between the parties to be communicated effectively (Hansen, 2002).

Within a conglomerate, or in the internal capital market, resources might be allocated more efficiently than in the external market. Imagine a conglomerate has two divisions, an innovation division and a cash cow. Since the cash cow has few growth opportunities, it has little use for the income it generates. Hence the income is allocated to the innovation division. If the innovation is independent, its high risk will make raising capital difficult (Rajan, Servaes and Zingales, 2000). However, the internal capital market theory is not supported by most empirical studies, which generally found that within conglomerates, divisions with good prospects have fewer resources than their independent peers while divisions with poor prospects receive more (Scharfstein, 1998). Researchers have offered several explanations for this phenomenon. First, even genuinely honest managers make mistakes. The larger the conglomerate gets, the more incompetent they become in the allocation of resources. Second, an independent entity chooses projects based on their net present value. But a conglomerate division, in order to have more resources, must also consider whether the project appears to be better than other divisions' projects (Rajan, Servaes and Zingales, 2000). This often results in divisional managers forgoing projects with high levels of risk or which take several years to pay off. Third, as remuneration for managers and divisional managers are both accounted as SG&A<sup>5</sup> expenses, reducing divisional managers' remuneration can strengthen the company's cash flow and increase the amount payable to managers. Divisional managers can be compensated by awarding their divisions more resources, regardless of their prospects (Scharfstein and Stein, 2000).

Conglomerates might also be the results of agency problems. Managers tend to build empires as a large company gives them strong sense of power and justifies large remuneration (Coffee, J. (1986). Large companies are also more difficult to take over, which insulates managers from market discipline.

Corporate life stage contributes to this debate on the efficiency of conglomerates. As the eBay case shows, conglomerates with divisions at different life stages are more likely to be inefficient and hedge fund activism to break them up is more likely to be beneficial.

In 2002, eBay needed an online payment system of its own to facilitate online transactions and acquired PayPal. The combination of eBay and PayPal created significant synergies as eBay introduced PayPal, which was then little known to the market, to its large client base (Castel-Branco, 2016). However, the synergies faded after most users of eBay became PayPal users. The combination started to create more costs than benefits as eBay and PayPal reached different stages of life. In 2013, PayPal grew by 22% while eBay's growth rate was 8% (Castel-Branco, 2016). The statistics shows that PayPal remained a growing company while eBay was approaching maturity. Different life stages mean different objectives. For PayPal, there were still many opportunities to explore. In 2011, PayPal announced that its new goal was to make PayPal a payment method at physical stores, replacing cash and credit cards (Icahn, 2014). This was a challenging goal especially after Google and Apple joined the race by introducing their digital payment methods. Hence PayPal should make little shareholder payouts and reserve most of its earnings for growth. Meanwhile, the goal of eBay should be to maintain its competitive edge, particularly against its main competitor Amazon. This was not an easy task either, as eBay lacked Amazon's level

<sup>5</sup> Sales, General and Administrative



of integration and had to compete against the benefits Amazon brought with its own logistic and storage systems (The Economist, 2015). Since eBay's business model was largely set, a large part of its earnings should be returned to shareholders. The combination of entities with divergent objectives made managers less focused and blurred each entity's objective. eBay's performance got improved by counting into PayPal's performance while PayPal was undervalued, operating under the shadow of eBay and its problems. PayPal's spinoff was beneficial as it not only allowed the two entities to focus, but also allowed investors to evaluate and monitor the two entities more effectively.

## 6. Corporate life stage and turnarounds

### 6.1 Facts

Hewlett-Packard (hereafter referred to as HP) had been on a declining path ever since the beginning of this century. HP specialized in the manufacturing of personal computers, printers and servers. This traditional focus on hardware caused the management's slow response to the development of cloud technology. As a result, a growing number of its server buyers switched to more advanced cloud computation offered by companies such as Apple and Amazon. This was a heavy blow to HP as the sales of servers contributed to a large part of its income (Darrow, 2016).

HP's board was divided, which resulted in frequent boardroom coups and the company having four CEOs in a decade. It also led to inconsistent strategies. For example, the strategy of Mark Hurd, the CEO from 2005 to 2010, was to maintain HP's competitive advantage in hardware (May, 2006). The view of his successor Leo Apotheker was to transform HP into a software company. Guided by this vision, in 2011 HP acquired Autonomy, a British software company, for more than \$10 billion. This transaction showed that the board was not only fragmented, but also ineffective. It later turned out that Autonomy had committed accounting fraud to inflate its earnings and the board approved HP's offer, which grossly overvalued Autonomy, without due diligence (Walker, 2016). Despite all of HP's problems, the board showed no sign in addressing any of them, except for its attempt to change the CEO again, which prompted the activism of Relational Investors, a hedge fund based in San Diego.

Relational Investors was managed by its founder, Ralph Whitworth. Promising that Relational Investors would remain in HP for at least two years, Whitworth succeeded in being appointed to the board (Walker, 2016). He then reached out to other large shareholders of HP. Relational Investors's lock-in agreement with HP served as a positive signal of the fund's commitment and confidence in the company's long-term value, which persuaded many shareholders to stay. Together the shareholders supported the incumbent CEO Meg Whitman and removed several directors. The situation was quickly stabilized.

Whitworth then worked with Whitman to structure a turnaround plan. The objectives of the company were decided to be keeping hardware's competitive position while catching up on the development of cloud technology. Accordingly, in 2014 the company was split into two entities, with HP Inc focusing on hardware and HP Enterprise focusing on the cloud (Darrow, 2016). To have more focus as well as to cover the loss of sales, other business divisions were offloaded. For example, HP's software business, including Autonomy, was sold to Micro Focus in 2016. The two entities also laid off a total of 85,000 employees to further cut costs (Darrow, 2016). The turnaround was widely acknowledged as successful. HP Enterprise's price nearly doubled its IPO price. HP Inc, which was burdened with most of old HP's debt, also managed to rise. It utilized its experience and intellectual property right on printing and made big progress in the area of 3d printing (Enderle, 2017). Whitworth's role in the turnaround was public acknowledged as he was later elected chairman of the board (Walker, 2016).

### 6.2 Analysis

Declining companies like HP are either turned around or liquidated. As demand for their products decreases, declining companies have small or negative income. To maintain as going concerns and to prepare for turnarounds, declining companies must raise capital, which, as in the case of HP, is usually achieved by making one-time cost cuts and selling non-core assets. These actions, collectively known as retrenchment (Robbins and Pearce, 1992), give declining companies time and resources to develop further turnaround plans.

Successful turnarounds require correct identification of the causes of decline. External causes are market or industry wide. For example, the two oil crisis and the resulting rise in oil price pushed many manufacturers of cars with high oil consumption into decline and bankruptcy (Chowdhury, 2002). Internal factors of decline include poor strategies, such as targeting a wrong group of consumers and poor operation, which refers to bad execution of good strategies (Robbins and Pearce, 1992). If a company decides its problem is strategic, it must develop new strategies and offload business divisions which do not fit the new strategies. It might need to make investments in its new focus, which requires capital to be raised via further cost and asset reduction. If the company's problem is operational, it needs to optimize its cost structure, which also entails retrenchment.

As cost reduction and asset sales are common objectives of hedge fund activism, hedge funds are highly specialized in retrenchment and might be beneficial to declining companies. More importantly, for declining companies, the need for immediate survival trumps most concerns for the long term. For example, undoubtedly HP would benefit from retaining its employees. But if the company does not take the myopic action of layoff, it

may not exist to realize the long-term benefits from loyal employees. However, this does not mean that declining companies and hedge funds are free to be unconditionally myopic. At the second stage, retrenchment must be carried out according to the company's strategy. For example, HP's new strategy focused on innovation. Thus it could not sell its R&D department, even though doing so would generate significant income. The problem of excessive retrenchment was mitigated at HP as Relational Investors' lock-in agreement ensured its commitment to the company in the long term.

Hedge fund activism is also likely to be beneficial to declining companies because corporate managers are often slow to recognize their companies' need for turnaround. Behavioral studies found that managers who are closely involved with the company business are overly optimistic, that they tend to attribute good corporate performance to internal factors and poor performance to external factors (O'Connor, 2003). When they attribute the problems to external factors, they also tend to believe that they are cyclical and that the downturn would reverse itself. Hedge fund activism can push managers to act and turnaround plans which are implemented at earlier stages of decline have larger chance of success.

## 7. Policy implications

The case studies support the hypothesis that hedge fund activism is more likely to be beneficial to companies at later life stages. This does not mean that these companies can never be harmed by hedge fund activism. It only highlights the importance of evaluating hedge fund activism based on firm-specific characteristics. A question logically follows is what other factors could influence the effect of hedge fund activism. This paper has briefly explored how a company's line of business, or more specifically its innovativeness, might affect the outcome of hedge fund activism. Product market competition is likely to be another factor. The product market has a corporate governance function as products of companies with severe agency problems would be outcompeted in the product market (Chou, Ng, Sibilkov, and Wang, 2011). Hence companies in concentrated markets are likely to have more serious agency problems and benefit from hedge fund activism. Future research should be conducted to test this hypothesis and explore other firm-specific factors.

Unfortunately, existing legal reform proposals have not recognized the distinctions among target companies and their effect on hedge fund activism. Built on the stereotype of myopic hedge fund activism, most reform proposals seek to mitigate the myopia problem by making activism more difficult for hedge funds. For example, in 2014 France changed loyalty shares from an opt-in default rule to an opt-out default rule. Currently, unless two-thirds of shareholders vote to opt out of the rule, voting rights of shareholders who have held their shares for two years would be doubled (Quimby, 2013). The rule seeks to address the myopia problem by diluting the positions of offensive activist shareholders. Such a broad-brush approach sacrifices the benefits of hedge fund activism. The rule is not even an effective solution to the myopia problem as holding shares for a certain period of time does not guarantee that the shareholders would hold them any longer. It also creates new problems. As managers generally hold their shares for long periods of time, the rule tips the balance between managers and shareholders by giving managers more power (Becht, Kamisarenka and Patjuste, 2018).

This paper argues that broad-brush legal rules such as the loyalty share rule are unlikely to regulate effectively because the effect of hedge fund activism differs for different companies. Instead, since hedge funds only take minority positions in companies and cannot succeed in activism without the support of other shareholders, legal reform should aim to encourage other shareholders to vote on hedge fund activism on a more informed basis. Particular focus should be placed on institutional shareholders. Pension funds, insurance companies and mutual funds have relatively large shareholdings and the expertise to evaluate hedge fund activism based on firm-specific factors. Right now they might not have incentives to do so because legal rules limit the size of their shareholdings and consequently their benefits from informed voting. Other factors, such as collective action problems and free-rider problems also act as disincentives against informed voting (Black and Coffee, 1994). Therefore, future research should be conducted on the costs and benefits of informed voting and legal reforms should create incentives for institutional shareholders to evaluate hedge fund activism.

## References

- Baxter, P and Jack, S. (2008) Qualitative Case Study Methodology: Study Design and Implementation for Novice Researchers. 13(4) *The Qualitative Report* 544-559
- Baysinger, B., Kosnik, R. and Turk, T. (1991) Effects of Board and Ownership Structure on Corporate R&D. *The Academy of Management Journal* 34(1), 205-214
- Bebchuk, L. (2013) The Myth that Insulating Boards Serves Long-Term Value. *Columbia Law Review* 113(6), 1637-1694
- Bebchuk, L., Brav, A. and Jiang, W. (2015) The Long-Term Effects of Hedge Fund Activism. *Columbia Law Review* 115, 1085-1156
- Bebchuk, L. and Fried, J. (2010) Paying for the Long-Term. *University of Pennsylvania Law Review* 158, 1915-1959
- Becht, M., Kamisarenka, Y. and Patjuste, A. (2018) Loyalty Shares with Tenure Voting: A Coasian Bargian? Evidence

- from the Loi Florange Experience” ECGI Law Working Paper No 398/2018
- Berle, A and Means, G. (1932) *The Modern Corporation and Private Property*. New York: Harcourt, Brace and World
- Boot, A. and Macey, J. (2004) Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance. *Cornell Law Review* 89(2), 356-393
- Boyson, N. and Mooradian, R. (2011) Corporate Governance and Hedge Fund Activism. *Review of Derivatives Research* 14(2), 169-204
- Brav, A., Jiang, W., Partnoy, F. and Thomas, R. (2008) Hedge Fund Activism, Corporate Governance and Firm Performance. *The Journal of Finance* 63(4), 1729-1775
- Cheffins, B and Armour, J. (2009) The Rise and Fall (?) of Shareholder Activism by Hedge Funds, ECGI Law Working Paper No 136/2009
- Chou, J., Ng, L., Sibilkov, V. and Wang, Q. (2011) Product Market Competition and Corporate Governance. *Review of Development Finance* 1(2), 114-130
- Clifford, C. (2008) Value Creation or Destruction? Hedge Funds as Shareholder Activists. *Journal of Corporate Finance* 14(4), 323-336
- Coffee, J. (1984) Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer’s Role in Corporate Governance. *Columbia Law Review* 84, 1145-1296
- Coffee, J. (2003) Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms. *Columbia Law and Economics Working Paper No 237*, 20
- Coffee, J. and Palia, D. (2016) The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance. *Journal of Corporation Law* 41(3), 545-607
- Fama, E. (1970) Efficient Capital Markets: A Review of Theory and Empirical Work. *The Journal of Finance* 25(2), 383-417
- Gantchew, N., Gredil, O., and Jotikasthira, C. (2018) Governance under the Gun: Spillover Effects of Hedge Fund Activism, ECGI Finance Working Paper No 562/2018
- Gillian, S. and Starks, L. (2007) The Evolution of Shareholder Activism in the United States. *Journal of Applied Finance* 19(1), 55-73
- Grossman, S and Hart, O. (1986) The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration. *Journal of Political Economy* 94(4), 691-719
- Hansen, M. (2002) Knowledge Networks: Explaining Effective Knowledge Sharing in Multiunit Companies. *Organization Science* 13(3), 232-248
- Hochberg, Y. (2011) Venture Capital and Corporate Governance in the Newly Public Firm. *Review of Finance* 16(2), 429-480
- Holmstrom, B. (1989) Agency Costs and Innovation. *Journal of Economic Behavior and Organization* 12(3), 305-327
- Jensen, M. and Meckling, W. (1976) Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics* 3(4), 305-360
- Jensen, M. and Murphy, K. (2004) Remuneration: Where We’ve Been, How We Got Here, What Are the Problems and How to Fix Them. ECGI Working Paper Series in Finance 44/2004
- Kahan, M. and Rock, E. (2007) Hedge Funds in Corporate Governance and Corporate Control. *University of Pennsylvania Law Review* 155(5), 1021-1093
- Klein, A. and Zur, E. (2009) Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors. *Journal of Finance* 64(1), 187-229
- Levitt, T. (1965) Exploit the Product Life Cycle. *Harvard Business Review* 43, 81-94
- Manne, H. (1965) Mergers and the Market for Corporate Control. *Journal of Political Economy* 73(2), 110-120
- Martin, S. and Partnoy, F. (2005) Encumbered Shares. *University of Illinois Law Review*, 775-814
- O’Connor, M. (2003) The Enron Board: The Perils of Groupthink. *University of Cincinnati Law Review* 71, 1233-1320
- Quimby, P. (2013) Addressing Corporate Short-Termism Through Loyalty Shares. *Florida State University Law Review* 40(2), 389-413
- Rajan, R., Servaes, H. and Zingales L. (2000) The Cost of Diversity: The Diversification Discount and Inefficient Investment. *The Journal of Finance* 55(1), 35-80
- Scharfstein, D. (1998) The Dark Side of Internal Capital Markets II: Evidence from Diversified Conglomerates. NBER Working Paper 6352
- Scharfstein, D. and Stein, J. (2000) The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment. *The Journal of Finance* 55(6), 2537-2564
- Sudarsanam, S. and Broadhurst, T. (2012) Corporate Governance Convergence in Germany through Shareholder Activism: Impact of Deutsche Boerse Bid for London Stock Exchange. *Journal of Management Governance* 16(2), 235-268
- The New York Stock Exchange Listed Company Manual. Retrieved from <http://wallstreet.cch.com/LCM/Sections/>
- Wachter, M. (2003) Takeover Defense When Financial Markets Are (Only) Relatively Efficient. *University of Pennsylvania Law Review* 151, 787-82

Flyvbjerg, B. (2013) Five Misunderstandings about Case Study Research. *Qualitative Inquiry* 12(2), 219,-245