

The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance

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Abstract

Hedge fund activism has increased almost hyperbolically. Although some view this trend optimistically as a means for bridging the separation of ownership and control, we review the evidence and find it far more mixed. In particular, engagements by activist hedge funds appear to be producing a significant externality: severe cut-backs in long-term investment (and particularly a reduction in investment in research and development) by both the targeted firms and other firms not targeted but still deterred from making such investments.

We begin by surveying the regulatory and institutional developments that have reduced the costs and increased the expected payoff from activism for activist investors. We give particular attention to new tactics (including the formation of “wolf packs” — loose associations of activist funds that do not constitute a “group” under the Williams Act) and new institutional structures (such as the alliance between an activist hedge fund and a strategic bidder struck in the recent Allergan takeover battle). Then, we survey the empirical evidence on how the investment horizons of firms are changing. Next, we review prior studies on the impact of activism, looking successively at (1) who are the targets of activism?; (2) does hedge fund activism create real value?; (3) what are the sources of gains from activism?; and (4) do the targets of activism experience post-intervention changes in real variables? We find the evidence decidedly mixed on most questions. Finally, we examine the policy levers that could encourage or curb hedge fund activism and consider the feasibility of reforms (including with respect to the law on insider trading). In particular, we consider possible private ordering responses, including new defensive tactics. Our policy preference is to find the least restrictive alternative.

1

Introduction

Hedge fund activism has recently spiked, almost hyperbolically.¹ No one disputes this, and most view it as a significant change. But their reasons differ. Some see activist hedge funds as the natural champions of dispersed and diversified shareholders, who are less capable of collective action in their own interest.² A key fact about activist hedge funds is that they are undiversified and typically hold significant stakes in the companies in their portfolios.³ Given their larger stakes and focused

¹See text and notes infra at notes 22–37.

²For a leading statement of this view, see R. J. Gilson and J. N. Gordon, “The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights”, *113 Colum. L. Rev.* 863, 2013. See also L. Bebchuk, “The Case for Increasing Shareholder Power”, *118 Harv. L. Rev.* 833, 2005.

³At the outset, it is necessary to acknowledge here that no generally accepted definition exists for the term “hedge fund.” Many commentators make this observation at the outset of their article or memorandum and then suggest a working definition. See L. C. Thomsen, D. M. Hawke, and P. E. Calande, “Hedge Funds: An Enforcement Perspective”, *39 Rutgers L.J.* 541, 543, 2008. Four characteristics usually identify hedge funds (and in any event most commentators seem to believe that they “know one when they see one”). Those four key characteristics are:

1. They are pooled, privately organized investment vehicles;
2. they are administered by professional investment managers with performance-based compensation and significant investments in the fund;

holdings, they are less subject to the “rational apathy” that characterizes more diversified and even indexed investors, such as pension and mutual funds, who hold smaller stakes in many more companies. So viewed, hedge fund activism can bridge the separation of ownership and control to hold managements accountable.

Others, however, believe that activist hedge funds have interests that differ materially from those of other shareholders. Presidential contender Hillary Clinton has criticized them as “hit-and-run activists whose goal is to force an immediate payout,”⁴ and this theme of an excessively short-term orientation has its own history of academic support.⁵ From this perspective, the rise of activist funds to power implies that creditors, employees and other corporate constituencies will be compelled to make wealth transfers to shareholders.

-
3. they cater to a small number of sophisticated investors and are not generally readily available to the retail-investment market; and
 4. they mostly operate outside of securities regulation and registration requirements.”

See R. Lee and J. D. Schloetzer, Director Notes: “The Activism of Carl Icahn and Bill Ackman,” (The Conference Board May 2014), 2. Because hedge funds are largely unregulated, they are not subject to the diversification requirements applicable to pension funds and most mutual funds.

⁴See A. R. Sorkin, “Clinton Aim Is to Thwart Quick Buck on Wall Street,” N.Y. Times, July 28, 2015 at B-1. For the full text of Hillary Clinton’s speech, see “Former Secretary of State Hillary Clinton, Democratic Presidential Candidate, Delivers Remarks at A Campaign Event in New York City,” Federal News Service, July 24, 2015.

⁵See, for example, I. Anabtawi, “Some Skepticism about Increasing Shareholder Power,” *53 UCLA L. Rev.* 561 2006; I. Anabtawi and L. Stout, “Fiduciary Duties for Activist Shareholders,” *60 Stan. L. Rev.* 1255, 2008; M. Kahan and E. B. Rock, “Hedge Funds in Corporate Governance and Corporate Control,” *155 U. Pa. L. Rev.* 1021, 1083, 2007 (viewing hedge funds as the “archetypal short-term investor”); W. W. Bratton and M. Wachter, “The Case Against Shareholder Empowerment,” *158 U. Pa. L. Rev.* 653, 2010; J. Fox and J. W. Lorsch, “The Big Idea: What Good Are Shareholders?,” *48 Harv. Bus. Rev.* 50, 51, 2012. Still others believe that “activist” hedge funds (or at least those with a high portfolio turnover) are systematically biased towards the short-term and thus persistently undervalue long-term investments. See B. Bushee, “The Influence of Institutional Investors on Myopic R&D Investment Behavior,” *73 Acc. Rev.* 315, 330, 1998. See also text and notes infra at notes 90–92. For similar views, see L. Stout, “The Mythical Benefits of Shareholder Control,” *93 Va. L. Rev.* 789, 2007; L. Dallas, “Short-Termism, The Financial Crisis and Corporate Governances,” *37 J. Corp. L.* 265, 2011.

This monograph explores this debate in which one side views hedge funds as the natural leaders of shareholders and the other side as “short-term” predators, intent on a quick raid to boost the stock price and then exit before the long-term costs are felt. We are not comfortable with either polar characterization and thus begin with a different question: Why now? What has caused activism to peak over the last decade at a time when the level of institutional ownership has slightly subsided? Here, we answer with a two-part explanation for increased activism: First, the costs of activism have declined, in part because of changes in SEC rules, in part because of changes in corporate governance norms (e.g., the sharp decline in staggered boards), and in part because of the new power of proxy advisors (which is in turn a product both of legal rules and the fact that some institutional investors have effectively outsourced their proxy voting decisions to these advisors).⁶ Second, activist hedge funds have recently developed a new tactic — “the wolf pack” — that effectively enables them to escape old corporate defenses (most notably the poison pill) and to reap high profits at seemingly low risk.⁷ Unsurprisingly, the number of such funds, and the assets under their management, has correspondingly skyrocketed.⁸ If the costs go down and the profits go up, it is predictable that activism will surge (and it has). But that does not answer the broader question (to which we then turn) of whether externalities are associated with this new activism.

Others have criticized hedge fund activism, but their predominant criticism has been that such activism amounts in substance to a “pump and dump” scheme under which hedge funds create a short-term spike in the target stock’s price, then exit, leaving the other shareholders to experience diminished profitability over the long-run.⁹ This

⁶See text and notes *infra* at notes 39–50.

⁷The “wolf pack” tactic and the case law on group formation are examined in the text and notes *infra* at notes 64–92. The term “wolf pack” was first recognized by the Delaware courts in *Third Point LLC v Ruprecht*, 2014 Del. Ch. LEXIS 64 (May 2, 2014) (upholding use of a novel poison pill because of threat posed by “wolf pack”).

⁸See text and notes *infra* at notes 30–36.

⁹These claims frequently emanate from the prestigious law firm of Wachtell, Lipton, Rosen & Katz. See, for example, M. Lipton and S. A. Rosenblum,

claim of market manipulation is *not* our claim (nor do we endorse it). Rather, we are concerned that hedge fund activism is associated with a pattern involving three key changes at the target firm: (1) increased leverage (2) increased shareholder payout (through either dividends or stock buybacks), and (3) reduced long-term investment in research and development (“R&D”). The leading proponent of hedge fund activism, Harvard Law Professor Lucian Bebchuk, has given this pattern a name: “investment-limiting” interventions.¹⁰ He agrees that this pattern is prevalent but criticizes us for our failure to recognize that “investment-limiting” interventions by hedge funds “move targets toward . . . optimal investment levels” because “managements have a tendency to invest excessively.”¹¹ We think this assumption that managements typically engage in inefficient empire-building is today out of date and ignores the impact of major changes in executive compensation. The accuracy of this assertion that managements are systematically biased towards inefficient expansion and investment becomes the critical question, as the scale and magnitude of “investment-limiting” interventions by activists have begun to call into question the ability of the American public corporation to engage in long-term investments or R&D. Is the new activism a needed reform to curb managerial self-interest or a hasty overreaction? Or somewhere in between?

This monograph has three basic aims: First, we attempt to understand and explain the factors that have caused the recent explosion in hedge fund activism. Second, we focus on the impact of this activism, including in particular whether it is shortening investment horizons and

Wachtell, Lipton, Rosen, and Katz, “Do Activist Funds Really Create Long Term Value?” The Harvard Law School Forum on Corporate Governance & Financial Regulation (July 22, 2014) (<http://blogs.law.harvard.edu/corpgov/2014/07/22/do-activist-hedge-funds-really-create-long-term-value/>). For a fuller statement, see M. Lipton and S. A. Rosenblum, “A New System of Corporate Governance: The Quinquennial Election of Directors,” *58 U. Chi. L. Rev.* 187, 1991. See also Bratton and Wachter, *supra* note 5, 653–654, 657–659; J. Fox and J. W. Lorsch, “The Big Idea — What Good Are Shareholders?,” *48 Harv. Bus. Rev.* 49, 51, July–Aug. 2012.

¹⁰See L. A. Bebchuk, A. Brav, and W. Jiang, “The Long-Term Effects of Hedge Fund Activism,” *115 Colum. L. Rev.* 1085, 1138, 2015.

¹¹*Id.* 1137, n. 103. For our reply, see text and notes *infra* at notes 144–140 and 206–212.

discouraging investment in R&D. Finally, we survey possible legal interventions, and evaluate them in terms of our preference for the least restrictive alternative. Although others have conducted lengthy surveys, the landscape of activism is rapidly changing, and thus we have doubts about the relevance of empirical papers that study hedge fund activism in earlier decades.¹² We also suspect that the recent success of such activism may be fueling a current “hedge fund bubble” under which an increasing number of activist funds are pursuing a decreasing (or at least static) number of companies that have overinvested (that is, made allegedly excessive investments in R&D or other long-term projects). This monograph is particularly focused on those market and legal forces that may be driving this bubble.

Here, a leading cause of increased hedge fund activism appears to be the development of a new activist tactic: namely, the formation of the hedge fund “wolf pack” that can take collective (or, at least, parallel) action without legally forming a “group” for purposes of the federal securities laws (which would trigger an earlier disclosure obligation).¹³ This new tactic, of course, explains our title. Hedge funds have learned that to the extent they can acquire stock in the target firm before the “wolf pack” leader files its Schedule 13D, announcing its proposed intervention, significant gains will follow for those who have already acquired that stock. Also, as later explained, this tactic allows activists to acquire a significant stake and negotiating leverage without triggering the target’s poison pill.

¹²For example, Bebchuk, Brav, and Jiang (2015) examine approximately 2000 activist hedge fund interventions between 1994 and 2007. *Id.*, 1090. Substantial as this effort is, hedge fund behavior in that era is different from today. In that era, there were relatively few activist hedge funds and possibly more opportunities for legitimate activist intervention. More recent studies support somewhat different results. Here, we give special attention to two such studies: (1) M. Becht, J. Franks, J. Grant, and H. F. Wagner, “The Returns to Hedge Fund Activism: An International Study” (Center for Economic Policy Research Discussion Paper No. 10507) (March 15, 2015) (available at <http://ssrn.com/abstract=2376271>), and (2) Yvan Allaire and Francois Dauphin, “The Game of ‘Activist’ Hedge Funds: Cui Bono?” (Institute for Governance of Public and Private Corporations, August 31, 2015) (available at <http://ssrn.com/abstract=2657553>).

¹³The “wolf pack” tactic and the case law on “group” formation is examined *infra* in the text and notes at notes 64–92.

Of course, new tactics are not necessarily bad and may be efficiency-enhancing. All studies have found that activist campaigns result *on average* in short-term gains for shareholders, but the evidence (as we will show) is decidedly more mixed with respect to long-term gains.¹⁴ Here, a word of caution needs to be expressed at the outset about these studies and the reliance that can be placed on them. Even if all these studies were to show long-term gains, they would still not resolve the key policy questions because of the following limitations on them:

1. The distribution of the returns from hedge fund activism shows high variance, with a significant percentage of firms experiencing abnormal stock price losses¹⁵; thus an individual company may be well advised to resist an activist's proposal, even if such proposals enhance shareholder value on average.
2. The positive abnormal stock returns on which the proponents of hedge fund activism rely do not necessarily demonstrate true gains in efficiency¹⁶; but may only indicate that the market has

¹⁴The fullest study of Schedule 13D filings (which covers some 298,398 filings and 48,902 initial filings from 1985 to 2012) finds on average abnormal turns of 4% on a Schedule 13D filing and higher 7% abnormal returns for initial Schedule 13D filings. See U. V. Lilienfeld-Toal and J. Schnitzler, What is Special About Hedge Fund Activism? Evidence from 13-D Filings, 2 and 25, Swedish House of Finance Research Paper No. 14–16 (available at <http://ssrn.com/abstract=2506704>, June 4, 2014). However, this study finds that the identity of the activist blockholder “plays a minor role in determining abnormal returns around 13D filings.” *Id.* Instead, the announcement of an activist plan and the relative possibility of a merger appear to drive results and increase the abnormal return. *Id.* For other studies finding an abnormal return of 6% to 7% on a Schedule 13D filing by an activist blockholder, see A. Brav, W. Jiang, F. Partnoy, and R. S. Thomas, “Hedge Fund Activism, Corporate Governance and Firm Performance,” *63 J. Fin.* 1729, 2008 (finding on average an abnormal short-term return of 7–8% over the period before and after the filing of a Schedule 13D announcing an activist's acquisition of 5% or more of the stock of a target firm); L. Bebchuk, A. Brav, and W. Jiang, *supra* note 10 (finding an approximately 6% average abnormal return during the 20-day window before and after a Schedule 13D filing). *Id.* at 1122 and Figure 2. These and other studies are considered *infra* at notes 143–200.

¹⁵See text and notes *infra* at notes 153–155.

¹⁶Even the leading advocates of hedge fund activism have softened their claims about causality. In the most recent revisions to their paper, Professors Bebchuk, Brav, and Jiang now concede that “causality issues in corporate governance and

given the target firm a higher expected takeover premium; that difference is important because not only will this temporary increase later erode if no takeover results, but in any event it does not demonstrate a true efficiency gain.¹⁷

3. These studies overlook (or give only inadequate attention to) the possibility that whatever shareholder wealth is created by hedge fund activism may reflect only a wealth transfer from bondholders, employees, or other claimants.¹⁸
4. The impact of hedge fund activism on American corporations (and long-term investment) cannot be adequately measured by looking only to the post-intervention performance at those com-

finance are notoriously difficult to resolve with absolute confidence” See Bebchuk, Brav, and Jiang, *supra* note 10, 1120. In contrast, we believe that causality in this contest is difficult to resolve with any reasonable confidence. Bebchuk, Brav, and Jiang further acknowledge that they cannot identify “the extent to which improvements are due to activist interventions.” *Id.* We agree. Although we think they have largely discredited the “pump and dump” theory that a stock drop automatically follows once activists exit the firm, they have not shown convincingly that activist interventions improve operating performance at target firms.

¹⁷Economists tend to assume that the takeover premium paid by the bidder reflects its ability to manage the target’s assets more efficiently (and thus justifies its willingness to pay an above market price for the target’s assets). But there are at least two significant reasons why the premium paid by a bidder in a takeover need not necessarily reflect the bidder’s greater efficiency: (1) the bidder may be acquiring market power and an increased market share that will result in oligopolistic pricing and a loss in social welfare; and (2) empirically, bidders frequently overpay (in which case, the premium is simply a wealth transfer from bidder shareholders to target shareholders). See B. S. Black, “Bidder Overpayment in Takeovers,” *41 Stan. L. Rev.* 597, 1989.

¹⁸The evidence on wealth transfers is discussed *infra* at notes 182 and 183. A related possibility is that apparent gains reflect only a reversion to the mean. See Y. Allaire and F. Dauphin, “Activist Hedge Funds: Creators of Lasting Wealth? What do The Empirical Studies Really Say?” at 12–13 (Institute for Governance of Private and Public Organizations) (July 2014) (reporting a “clear pattern of convergence towards the mean”). Their point is that firms that outperform or underperform the mean over one period move closer to the mean over the next period. Professors Allaire and Dauphin have renewed their criticisms of Bebchuk, Brav, and Jiang, *supra* note 10, after the latter’s revision of their paper in December 2014. See Yvan A. and F. Dauphin. *Still Unanswered Questions (and New Ones) to Bebchuk, Brav, and Jiang*: Institute for Governance of Private and Public Organizations, January 2015.

panies that experience a hedge fund intervention; this ignores the deterrent impact of such activism on the many more companies that experience no such intervention, but that increase leverage and dividends or reduce long-term investments, in fear of the growing risk of such an activist intervention. This perverse deterrent effect, as many firms cease to invest in R&D or other long-term investments and instead increase shareholder payout, has been largely ignored by most commentators.¹⁹

5. The targets of hedge fund activism are not randomly distributed, but rather tend to be underperforming companies. Such companies often revert to the mean, and it cannot therefore be assumed that hedge fund activism caused any improvement detected in their post-intervention performance. Indeed, recent research with a control group of companies selected to match target companies (but which did not experience a hedge fund engagement) finds that the control group outperformed the target companies, thus suggesting that the impact of hedge fund activism may actually have been to retard the improvement of these target companies.²⁰

Our primary concern is with the possibility that the increasing rate of hedge fund activism is beginning to compel corporate boards and managements to forego long-term investments (particularly in R&D) in favor of a short-term policy of maximizing shareholder payout in the form of dividends and stock buybacks. This would represent a serious externality, even if private gains resulted. We do not suggest that this evidence justifies barring hedge fund activism, but we do suggest (with Hillary Clinton) that it may justify greater transparency and reducing the tax subsidy for such activities.

With these concerns in mind, we begin in Section 2 with an analysis of those factors that have spurred greater activism on the part of hedge funds. Then, in Section 3, we consider evidence suggesting that,

¹⁹A few commentators have noticed this impact. See text and notes *infra* at notes 113–119 and 144–140.

²⁰K. J. Marjin Cremers, Erasmo Giambana, Simone M. Sepe and Ye Wang, “Hedge Fund Activism and Long-Term Value” (Nov. 19, 2015) (available at <http://ssrn.com/abstract=2693231>). See also text and notes *infra* at notes 166 to 168.

as the composition of a firm's shareholder population shift towards more "transient" holders, so too does its investment horizon shorten. Growing evidence shows that hedge fund engagements with firms result in dramatic decreases in investments by such firms in R&D in subsequent years. Our broader concern is not simply with the immediate targets of activism, but with the general deterrent effect of hedge fund activism. Does it reduce managerial agency costs or deter long-term investments — or both?

In Section 4, we survey recent studies to reach assessments about: (1) who are the targets of hedge fund activism; (2) the stock price returns from hedge fund activism and the distribution of those returns; (3) the degree to which wealth transfers explain the positive stock price returns to activism; (4) the post-intervention evidence about changes in operating performance of hedge fund targets; and (5) the holding periods and exit strategies of hedge fund activists.

In Section 5, we evaluate some policy options, looking for the least drastic means of accomplishing policy goals. Our conclusion in earlier sections that causality has not been adequately established leads us to examine both (1) what policy options should be considered that would protect shareholders and other constituencies without precluding hedge fund interventions; and (2) what forms of private ordering could be reasonably employed by target companies to adjust the balance of advantage in these corporate battles (and how should courts respond to these efforts). Finally, Section 6 offers a brief conclusion that surveys how the changing structure of shareholder ownership and the recent appearance of temporary shareholder majorities complicates corporate governance, both empirically and normatively.