# Validation Capital

## Alon Brav,[*] Dorothy Lund[**] and Edward Rock[***]

*Although it is well understood that activist shareholders challenge management, they can also serve as a shield. This Article describes "validation capital," which occurs when a bloc holder's—and generally an activist hedge fund's—presence protects management from shareholder interference and allows management's pre-existing strategy to proceed uninterrupted. When a sophisticated bloc holder with a large investment and the ability to threaten management's control chooses to vouch for management's strategy after vetting it, this support can send a credible signal to the market that protects management from disruption. By protecting a value-creating management strategy that might otherwise be misjudged, providers of validation capital benefit all shareholders, including themselves. However, validation capital may also have a dark side: it could be used to entrench under-performing management from outside interference that would benefit the company and its shareholders. In this scenario, the bloc holder acts as a hired "bodyguard" who receives a side payment in exchange for the promise to ward off other investors. We argue that legal and market forces do much to constrain the corrupt form of validation capital, and our empirical study of hedge fund activism events from 2015 offers evidence in support of our theory. We find that although side payments from corporate management to hedge funds are relatively common, they tend to be small and not of the magnitude necessary to induce corruption of the sophisticated funds capable of generating a persuasive signal.*

## Introduction

In 2014, the activist hedge fund Trian Fund Management surprised the banking world when it announced that it had accumulated a billion-dollar investment in the Bank of New York (BNY) Mellon, representing a 2.5% stake.[1] Trian had engaged in several hard-fought proxy contests at blue chip companies since its founding in 2005, so the investment might have signaled

---

* Peterjohn-Richards Professor of Finance, Fuqua School of Business, Duke University, ECGI, and National Bureau of Economic Research.

** Assistant Professor of Law, USC Gould School of Law.

*** Martin Lipton Professor of Law and co-director of the Institute for Corporate Governance and Finance, NYU School of Law and ECGI. For insightful comments, the authors thank Allison Bennington, Brandon Boze, Lawrence Cunningham, Ed Garden, Marc Gross, Martin Lipton, Ted Mirvis, Brian Schorr, Bob Thompson, VC Joseph Slights and participants in the 27th ILEP Symposium and the Berkeley Law, Accounting, and Business Workshop. For excellent research assistance, the authors thank Hayk Badalyan, Michael Larson, and Xin Xiong.

1. David Benoit & Saabira Chaudhuri, *Peltz's Trian Plants Its Flag in BNY Mellon*, WALL ST. J. (June 30, 2014, 7:14 PM), https://www.wsj.com/articles/trian-takes-stake-in-bank-of-new-york-mellon-1404135716 [https://perma.cc/QT4R-KAZM].

the beginning of a battle.[2] But from the start, Trian sought management's cooperation; Trian's founder Nelson Peltz declared early on that the fund was only interested in attempting a constructive dialogue with the bank.[3] In particular, Trian pushed the bank to execute on key initiatives that were already in the works, including revamping management compensation, investing in technology, and cutting excess costs.[4] Initially, the bank rebuffed Trian's advances and only grudgingly offered a board seat to Trian's CIO Ed Garden after the investor threatened to wage a proxy contest.[5] But ultimately, Trian would prove to be a boon to management.

In particular, a few months later, another hedge fund—Marcato Capital Management—disclosed a 1.6% stake in the bank.[6] Marcato's plans for the bank were much less collaborative. Specifically, the fund had made several public statements disparaging CEO Gerald Hassell and the rest of the BNY Mellon management team, arguing that it was time for "new executive talent."[7] The hedge fund also argued for aggressive cost cutting measures that included "thousands of job cuts"—Hassell's included.[8] Other investors echoed Marcato's concerns, but not Trian. Instead, Garden publicly supported Hassell and his plans for the bank;[9] ultimately, this support from a sophisticated outside investor helped the bank "avoid[] a potentially bitter proxy contest."[10] In exchange for this protection, BNY Mellon agreed to

---

2. Geoff Colvin, *The Investor That Tripped on GE & P&G*, FORTUNE (Nov. 26, 2018, 5:30 AM), https://fortune.com/2018/11/26/nelson-peltz-ge-pg-stock/ [https://perma.cc/KA79-36MU].

3. Lawrence Delevingne, *Trian Nabs BNY Mellon Board Seat*, CNBC NET/NET (Dec. 3, 2014, 11:47 AM), https://www.cnbc.com/2014/12/03/trian-nabs-bny-mellon-board-seat.html [https://perma.cc/2QTF-Q5FM].

4. Ethan Klingsberg & Ed Garden, *Trian and the Bank of New York Mellon*, 17 M&A J., no. 8, at 1, 1.

5. *Id.* at 2; David Benoit, *BNY Mellon Is Latest Firm to Yield to Activist Investor*, WALL ST. J. (Dec. 2, 2014, 7:14 PM), https://www.wsj.com/articles/bank-of-new-york-mellon-gives-activist-trian-fund-a-board-seat-1417524537 [https://perma.cc/A97Z-PQQH]; Aaron Elstein, *BNY Mellon Brings Activist on Board*, CRAIN'S N.Y. BUS. (Dec. 1, 2014, 11:00 PM), https://www.crainsnewyork.com/article/20141202/BLOGS02/141209957/bny-mellon-brings-activist-on-board [https://perma.cc/2DVS-PRVW].

6. Delevingne, *supra* note 3.

7. Tom Braithwaite & Stephen Foley, *Activist Investors Take Aim at Chief of Bank of New York Mellon*, FIN. TIMES (May 13, 2015), https://www.ft.com/content/148793c2-f84d-11e4-8bd5-00144feab7de [https://perma.cc/2VSL-AZFZ].

8. *Id.*

9. David Benoit, *BNY Mellon CEO Faces Shareholder Criticism*, WALL ST. J. (Mar. 10, 2015, 7:58 PM), https://www.wsj.com/articles/bny-mellon-ceo-faces-shareholder-criticism-1426005897 [https://perma.cc/2CSV-UUXF].

10. Reuters Staff, *Activist Hedge Fund Marcato Exited BNY Mellon Position in Fourth Quarter: Filing*, REUTERS (Feb. 14, 2017, 10:57 AM), https://www.reuters.com/article/us-hedgefunds-marcato-bnymellon/activist-hedge-fund-marcato-exited-bny-mellon-position-in-fourth-quarter-filing-idUSKBN15T29B [https://perma.cc/F99V-AQL4]; *see also* Braithwaite & Foley, *supra* note

accelerate the process of change. Ultimately, this resolution worked out well for both Trian and BNY Mellon: over the subsequent five and a half years, BNY Mellon's stock price climbed from around $31 to approximately $55.[11]

This example showcases the phenomenon of "validation capital," in which bloc holders intervene to shield management from outside interference and thereby allow the executive team's preexisting strategy to proceed uninterrupted. While most scholars have focused on the ways that activist shareholders threaten management,[12] hedge fund activists can sometimes serve as a "shark repellent"[13] or a modern-day "white squire."[14] As is true of much shareholder intervention in governance, the provision of validation capital can represent a positive or negative for firm performance and shareholder value, depending on the circumstances. In the "happy story," validation capital addresses information asymmetries between management and outside investors that may cause outsiders to misjudge management's

---

7 (quoting Garden's pledge of support for "Gerald [Hassell] and the management team" of BNY Mellon and his promise to "hold them accountable for meeting the company's financial targets").

11. Client Portfolio of BNY Mellon Corporation (2014–2020), TRIAN PARTNERS, https://trianpartners.com/portfolio-client/bny-mellon/ [https://perma.cc/5AYW-7B7U]; John Vincent, *Tracking Nelson Peltz's Trian Fund Management Portfolio - Q1 2020 Update*, SEEKING ALPHA (May 30, 2020, 11:52 AM), https://seekingalpha.com/article/4351072-tracking-nelson-peltzs-trian-fund-management-portfolio-q1-2020-update [https://perma.cc/VBZ8-Y9AF].

12. *See, e.g.*, Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1, 4 (2020) (analyzing the role of settlement agreements in activist proxy fights); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1027 (2007) (examining "the 'dark side' of activism—instances where the interests of activist hedge funds conflict with those of their fellow shareholders"); Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1871 (2017) (exploring whether "activist hedge funds are good for, a danger to, or of no real consequence to public corporations").

13. We use the phrase "shark repellent" to describe the effect of discouraging activist hedge funds from seeking to change management's strategy. For an example of an earlier and related use of the phrase, referring to efforts to discourage hostile takeovers during the 1980s, see William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341, 342 (1983). We use the phrase advisedly and do not mean to suggest that activists who seek to change management strategy are necessarily "sharks" in the negative sense sometimes used. For an analysis of relational investing and its shark repellent effect, see Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 988–89 (1994). *See also* Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033, 1034 (1994) ("[R]elational investing is used to foreclose or reduce hostile takeover threats, replacing this form of external discipline with enhanced internal discipline by the relational investors.").

14. "White squire" is a term coined in the 1980s to refer to an investor who takes a large (but not controlling) position to prevent a hostile takeover. Lawrence A. Cunningham, *The Case for Empowering Quality Shareholders*, 46 B.Y.U. L. REV. 1, 28 (2021) [hereinafter Cunningham, *Quality Shareholders*].

quality and vision for future successful performance.[15] When a sophisticated bloc holder with a large investment and the ability to threaten management's control chooses to vouch for management's strategy after vetting it, this can send a credible signal to the market that protects management from disruption. This protection ultimately benefits all of the shareholders, including the bloc holder, whose shares will increase in value.

As this discussion reveals, validation capital differs from other mechanisms of bloc holder influence in governance that have been explored in the literature. For example, scholars have observed that bloc holders can play an important role in monitoring management and directly intervening to force operational changes when the company goes in the wrong direction.[16] Validation capital is different. In particular, validation capital does not depend on the bloc holder redirecting management's plans; the provider of validation capital instead *certifies* management's strategy and in so doing, discourages other shareholders from supporting proposals to change direction.

Scholars have also observed that even passive bloc holders can influence management through their threat of an exit or their decision to hold when exit is easy.[17] This mechanism is more closely related to validation capital, as it similarly anticipates that a bloc holder's presence operates as a signal and therefore encourages management to continue to pursue the correct operational decisions. In addition, both mechanisms rely on some degree of bloc holder sophistication. For the threat of exit to matter to management, the bloc holder must have the ability to monitor and acquire information about the firm that it may trade on, and the bloc holder's trading activity must be expected to affect stock price.[18]

---

15. For a related analysis focusing on a different channel, see Ronald J. Gilson & Jeffrey N. Gordon, *Boards 3.0: An Introduction*, 74 BUS. LAW. 351, 354 (2019) (arguing for private equity style "empowered directors" who can reassure investors and benefit companies by overcoming information asymmetries).

16. *See* Rock, *supra* note 13, at 988 (discussing the role of relational investors who provide "continuous and textured monitoring" through a position on the board); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 465 (1986) (exploring a model in which the presence of a large minority shareholder functions to monitor the performance of management); *see also* Jill E. Fisch & Simone M. Sepe, *Shareholder Collaboration*, 98 TEXAS L. REV. 863, 866 (2020) ("[E]mpowered and actively informed investors offer[] a new source of well-resourced and sophisticated firm-specific knowledge from *outside* the corporation.").

17. *See* Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645, 2647 (2009) (showing "that the ability of large shareholders to exit . . . often helps in reducing agency costs and aligning managerial decisions with shareholders' preferences"); Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481, 2484 (2009) ("If a blockholder has retained her stake despite low earnings, this is a particularly positive indicator of fundamental value if she could easily have sold instead.").

18. Edmans, *supra* note 17, at 2484.

But while providers of validation capital are also sophisticated and informed investors whose activities can affect the company's stock price, the mechanism for influence is different: validation capital affects the direction of the firm through "shielding." When a well-incentivized, well-informed bloc holder with the power to disrupt management instead vouches for management's strategy, it affects other investors in two ways: First, it builds support for management among the general shareholder population. Second, because of this support, activists will be less likely to prevail in a challenge to management's strategy and, as a result, less likely to attempt to do so.

In some cases, an investor will validate management solely as a result of its decision to buy or hold (think Warren Buffett); in other cases, providers of validation capital play a more active role in shielding management. As the Trian example reveals, providers of validation capital may secure inside information by serving on the board, and they sometimes serve as an "anchor" or "reference" investor by advertising their alignment with management, either in public statements or in conversations with other shareholders. This support ultimately allows management to execute its plans without the distraction of a proxy contest. In some cases, as the Trian example further demonstrates, the promise to shield can also serve as a catalyst for management action. As discussed, Trian's validation came in exchange for management and the board's commitment to execute on proposed changes that had been contemplated for some time.

Although validation capital can be beneficial, like any relational investing, it can have a dark side. In this setting one worries that a bloc holder will help to entrench underperforming management from outside interference that would benefit the company and its shareholders in exchange for a direct or indirect side payment.[19] In this scenario, the bloc holder acts as a hired "bodyguard" who receives a side payment in exchange for the promise to ward off other investors that seek to threaten management's control. In light of the bloc holder's expectation that its protection will depress the company's stock price, a side payment is necessary to induce its participation. Such a side payment could take various forms including preferential investment terms upon entry; a premium upon exit; extra compensation for directors; and even inflated reimbursement for proxy expenses.[20] Providing "bodyguard"

19. *See* Rock, *supra* note 13, at 989 (discussing "corrupt" relational investors who acquire large stakes "in the firm at a discount in exchange for protecting incumbent managers from displacement or, more generally, from threats to their autonomy"). In this Article, we consider the incentives that a bloc holder would have to engage in corrupt validation capital. Even if doing so were profitable, many activists investors would choose not to do so, whether for ethical reasons or, as discussed more below, out of a concern for harm to their reputation. *See infra* notes 90–93 and accompanying text.

20. Although this Article focuses on activist hedge fund bloc holders as providers of validation capital, other types of bloc holders may be able to command different types of side payments. For

services may be rational when the side payment is large enough to offset the bloc holder's expected losses as a result of the decline in the company's share price.[21]

Given the proliferation of bloc holders and their increasingly active role in governance, it is important to understand the potential implications of validation capital for firm performance and value and the relative likelihood of the virtuous and corrupt variants. This Article begins to tackle this question. In so doing, the Article first surveys the legal and market mechanisms that constrain corrupt relational investing. Side payments to bloc holders by public company management will generally be disclosed under federal securities law.[22] In extreme circumstances, the payment of a side payment could trigger heightened judicial review by Delaware courts.[23] Ultimately however, these legal requirements may only somewhat deter side payments; instead, we believe that market mechanisms, facilitated by disclosure, provide the key constraint. In particular, corrupt relational investing can only be rational in very limited circumstances. A management team that seeks protection must be assured that the bloc holder's support will be effective against other investors, and it must also be assured that the bloc holder will be willing to hold on to the block for a potentially long period of time and not defect. Likewise, a hedge fund that plans to provide "bodyguard" services must worry about returns as well as the risk that reputational harm will compromise future interventions. This may lead the investor to require a prohibitively large payment as compensation for this risk.[24] We argue that these forces do much to inhibit management teams from offering side payments and constrain activist shareholders from accepting them.

Our empirical study offers evidence in support of our prediction that corrupt validation capital will be rare or non-existent. We studied a cross section of public companies targeted by hedge fund activists in 2015[25] and generated little evidence of substantial side payments of the size necessary to

---

example, a mutual fund bloc holder could be hired to manage corporate pension fund assets as a side payment.

21. *See* Rock, *supra* note 13, at 1002 (explaining how an investor's cost–benefit calculation changes when protection money is offered).

22. *See infra* subpart I(B).

23. *See infra* subpart I(B).

24. *See infra* subpart I(C).

25. We chose the year 2015 because it featured a large number of activism events relative to other years and because it allowed us sufficient time post-intervention to determine whether a side payment was paid. *See* SULLIVAN & CROMWELL LLP, REVIEW AND ANALYSIS OF 2020 U.S. SHAREHOLDER ACTIVISM AND ACTIVIST SETTLEMENT AGREEMENTS 18–19 (Dec. 2, 2020), https://www.sullcrom.com/files/upload/sc-publication-review-analysis-2020-US-shareholder-activism.pdf [https://perma.cc/W8RQ-DXZX] (showing that of the past six years, 2015 was the second highest in terms of activist events, second only to 2019).

induce the corrupt form of validation capital.[26] That was so despite the fact that our analysis demonstrated that many opportunities for side payments exist: management can offer expense reimbursement, differential pay for the activist director(s), a promise to repurchase shares, consulting fees, a private placement of shares, notes or warrants, and warrant amendments. Our study indicated that management teams and activists enter into such arrangements in, at most, a third of all activist events, and a closer look at these events indicated that they are not likely candidates for corruption. In other words, it appears that market and legal mechanisms operate to constrain the corrupt form of validation capital, at least with regard to U.S. public companies and activist hedge funds. We conclude with implications for investors and policymakers and also highlight open questions for future research.

## I. Background

This section provides background for our empirical study. It first discusses the predominance of bloc holders in the U.S. capital markets and then describes the phenomenon of validation capital, whereby the presence of a bloc holder can insulate management from disruption. It discusses how validation capital can benefit shareholders and the market but notes that validation capital can also constitute corrupt relational investing when an underperforming management team pays a bloc holder in exchange for protection. It then outlines the legal framework and market forces that constrain management from giving side payments and activist investors from accepting them.

### *A. Bloc Holders and Validation Capital*

Over the last several decades, the U.S. equity market has transformed from one characterized by dispersed ownership into one in which the majority of equity is held by institutional shareholders.[27] From 1987 to 2009, institutional ownership of the largest 1,000 U.S. corporations grew from

---

26. Our results are therefore consistent with Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, who searched within a sample of activist settlements for evidence of "greenmail" and found that "[b]uybacks of activist shares occur in a very small fraction of settlement agreements, and when they do occur, they are typically executed at the market price." Bebchuk et al., *supra* note 12, at 3.

27. *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 724 (2019) ("The average combined stake in S&P 500 companies held by the Big Three essentially quadrupled over the past two decades, from 5.2% in 1998 to 20.5% in 2017."); Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1378 (2009) ("Although it is widely believed that U.S. ownership is diffuse, empirical support for this proposition is surprisingly scant."); Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 365 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) ("As is now widely recognized, institutional ownership of equities has been transformed over the last 60 years.").

46.6% to 73%.[28] As of 2017, institutions owned nearly 80% of the market value of the U.S. Russell 3000 index and 80.3% of the S&P 500 index.[29] And the overall effect of the growth of institutional shareholding has been to concentrate the U.S. equity market in the hands of institutional bloc holders. As of 2009, 96% percent of U.S. firms had at least one shareholder with a 5% stake.[30] A recent OECD report notes that in the U.S., the average combined ownership held by a company's ten largest institutional investors is 43%.[31]

As the equity market has become increasingly concentrated, an extensive literature has considered the role that bloc holders play in corporate governance. Observers initially predicted that the rise of institutional investing in the U.S. would lead to improved governance at companies and would minimize managerial agency costs in particular.[32] Bloc holders should have strong incentives to gather costly information since their large investment provides the appropriate financial incentives to evaluate companies and their management and directly intervenes to help them develop profitable strategies.[33] By monitoring and guiding companies, bloc holders not only benefit from the increased value of their position in the company, but they also benefit the company's other shareholders.[34]

---

28. Rock, *supra* note 27, at 365 n.7 (citing MATTEO TONELLO & STEPHAN RABIMOV, THE CONFERENCE BD., THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 27 tbl.13, chart 14 (2010)).

29. *80% of Equity Market Cap Held by Institutions*, PENSIONS & INV. (Apr. 25, 2017, 1:00 AM), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions [https://perma.cc/Z2UF-GRGS].

30. Holderness, *supra* note 27, at 1378.

31. ADRIANA DE LA CRUZ, ALEJANDRA MEDINA & YUNG TANG, OECD CAPITAL MARKET SERIES, OWNERS OF THE WORLD'S LISTED COMPANIES 23 (2019), https://www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.pdf [https://perma.cc/A7VV-G27N].

32. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 834–35 (1992) (discussing how scale economies allow institutional shareholders to improve governance without micromanaging the company); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 575 (1990) (positing that procedural reform on issues exhibiting economies of scale could activate institutional shareholder interest in governance); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1288–89 (1991) (using the developing trend of institutional activism as the basis for a comparative examination of regulatory policy choices); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865–67 (1991) (proposing a corporate governance strategy for institutional investors that focuses on their unique role as growing holders of the market); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 797–98 (1993) (describing the promise and pitfalls of pension fund activism).

33. Edmans, *supra* note 17, at 2485–86.

34. Even then, there were skeptics. Edward Rock argued that the agency costs of money management undermined the optimistic accounts of institutional investor activism, with both rational apathy and free riding effects reappearing at the asset management level. Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 451–52 (1991).

But direct intervention is not the only way that bloc holders play a beneficial role in governance: bloc holders can strengthen managerial discipline through their trading.[35] For example, if a bloc holder's research reveals that a company's poor performance is due to managerial myopia that is likely to continue, it can sell its stake, which will depress the company's stock price and send a signal to the company and the market about management's quality. In other words, direct intervention by investors may be unnecessary if management understands that an informed bloc holder with a liquid stake will exit if the company underperforms.[36] By contrast, if the bloc holder determines that the market is undervaluing a desirable long-term investment and holds, a decision by the bloc holder not to sell attenuates any negative stock price reaction, which helps shield management from scrutiny and displacement.[37]

Validation capital is related to this latter mechanism. It occurs when a bloc holder's presence protects management from shareholder interference and thereby allows the executive team's pre-existing strategy to proceed uninterrupted. Warren Buffett is a prototypical example of a provider of validation capital: when he buys a bloc in a company, this signals to the market that management's vision should not be disrupted.[38] In other words, an investment from Warren Buffett benefits the company and its shareholders even without his bringing strategic or operational expertise to the table. Instead, the value comes from his decision to hold when exit is possible or buy when others are selling, which alerts the market that a sophisticated investor has faith in management and their plans.

As the Buffett example reveals, validation capital is typically provided by a sophisticated investor with market credibility. Activist hedge funds often serve in this capacity, not only because of their sophistication but also

35. Edmans, *supra* note 17, at 2504.

36. Note that bloc holders need not sell in equilibrium: management will anticipate that underperformance will lead to exit, and that prospect will be sufficient to constrain management misbehavior. *See* Admati & Pfleiderer, *supra* note 17, at 2677 ("Our analysis shows that . . . for the threat of exit to be effective, it is not necessary that exit actually occurs frequently."); Edmans, *supra* note 17, at 2484 ("[T]he power of loyalty relies on the threat of exit." (emphasis omitted)).

37. Edmans, *supra* note 17, at 2482.

38. *Id.*; Liam Denning, *Oxy Stock Offers the Buffett Experience (Sort of)*, BLOOMBERG (Oct. 15, 2019, 11:14 AM), https://www.bloomberg.com/opinion/articles/2019-10-15/occidental-petroleum-stock-is-a-buffett-adjacent-experience [https://perma.cc/92NA-DVE4]; Tara Lachapelle, *When Warren Buffett Sours on Goldman Sachs, Time to Worry*, BLOOMBERG (May 15, 2020, 6:41 PM), https://www.bloomberg.com/opinion/articles/2020-05-15/warren-buffett-sours-on-goldman-sachs-time-to-worry [https://perma.cc/8374-MSB7]; *see also* LAWRENCE A. CUNNINGHAM, BERKSHIRE BEYOND BUFFETT: THE ENDURING VALUE OF VALUES 185–86 (2014) (highlighting examples that showcase the long-term value of Buffett's interventions); Cunningham, *Quality Shareholders*, *supra* note 14, at 7 (2021) (describing Warren Buffett as a prototypical "quality shareholder[]"); Rock, *supra* note 13, at 993–94 (discussing various Buffett investments and their validation effect).

because of their ability to challenge management. In other words, when a sophisticated investor with the power to challenge management vets management's strategy and then supports it, this sends a particularly strong signal to the market—and to other investors who may be considering an intervention in particular—that management is charting the right course. In addition, providers of validation capital tend to do more than maintain their investment in the company; they often take an active role in governance, perhaps by serving on the board, which improves the quality of the signal.[39] They may also serve as an "anchor" or "reference investor" by communicating information about management's strategy and voicing support to other shareholders. A provider of validation capital with a long investment time horizon can engage with management—and provide reassurance to the market—on long-term strategic initiatives that might produce what seem to be less attractive short-term results but which are intended to benefit the company over time.

This communication of information and vocal support can provide a powerful validation effect and serves as a warning to other investors who might advance a competing vision in two ways. First, the "validating" bloc holder's confidence in the existing management strategy, given its information and incentives, should make other investors rethink their alternative strategies. Second, the likelihood that other shareholders—the ones whose votes will decide any proxy contest—will be convinced by the validating bloc holder's confidence in the existing strategy will undermine, if not foreclose, other investors' paths to success.

Validation capital can take one of two forms. First, *ex ante* validation capital occurs when management draws in a bloc holder on a clear day, before hostile investors have targeted the company.[40] In other words, management may believe that the presence of a sophisticated, friendly bloc holder can serve as an insurance policy and protect management against activist investors in the future.[41]

As an example of *ex ante* validation capital, consider how the technology company Seagate solicited a 4% investment from the well-known

---

39. *See supra* notes 5–10 and accompanying text.

40. *See* Cunningham, *Quality Shareholders*, *supra* note 14, at 28–29 (advising managers to attract and empower quality shareholders); *see generally* Lawrence A. Cunningham, *Cultivating Quality: Time to Revise and Update the Shareholder Cultivation Literature*, OHIO ST. BUS. L.J. (forthcoming 2021) (explaining how managers can attract high quality bloc holders).

41. For an example of how a bloc holder can chill future activism events, consider how the State of Wisconsin Investment Board, a long-time Oshkosh shareholder, protected the company from a hostile bid by Carl Icahn. Barry B. Burr, *Wisconsin Board Backs Oshkosh in Dispute with Icahn*, PENSIONS & INV. (Nov. 2, 2012, 1:00 AM), https://www.pionline.com/article/20121102/ONLINE/121109971/wisconsin-board-backs-oshkosh-in-dispute-with-icahn [https://perma.cc/9V2B-QQDM].

activist hedge fund ValueAct Capital in 2016.[42] In addition to encouraging the investment, the company also invited the fund to have an observer present at board meetings.[43] Why would a company invite a sophisticated investor with a track record of hostile engagements to invest and participate in governance? One news article aptly noted the shark repellent effect of this move: "Historically, corporations have been hesitant to bring activists into the boardroom for fear of the disruption and conflict it might cause. But Seagate seems willing to take that risk, conceivably in the hope of preventing an even more disruptive future public conflict."[44]

As another example, consider how GE CEO Jeff Immelt invited Trian to invest in the company in 2015, during a period when the company "had gone off track" and was under pressure from investors to cut costs and improve its share price.[45] Trian assented and took a $2.3 billion position (0.8%) in the beleaguered company.[46] A few months later, Trian embraced its role as a reference investor, publishing a white paper that "powerfully endorse[d] GE's strategy and its stock," arguing that Immelt's plans were "under-appreciated in the market."[47] The company's stock rose, and dissidents were quieted for years.[48]

Second, management can also seek validation capital *ex post*, once it has learned that activists who disagree with its current plans are likely to intervene or have already acquired stock. When management perceives a threat to its control, it may cultivate an existing bloc holder with the hope that it can win the bloc holder's support, which will serve as a shark repellent. The introduction noted an example involving Trian and BNY Mellon, where BNY Mellon brought a hedge fund director on its board, which helped the company avoid a proxy fight with a dissident shareholder.[49] As another example, consider how Microsoft avoided a proxy battle by inviting ValueAct, an activist fund with a $2 billion investment in the company (representing a 0.8% stake), to place a director on its board.[50] Before that

42. Dan Batista, *Is There Method in Seagate's Madness in Inviting an Activist Wolf into the Fold?*, FASKEN: TIMELY DISCLOSURE (Oct. 3, 2016), https://www.timelydisclosure.com/2016/10/03/is-there-method-in-seagates-madness-in-inviting-an-activist-wolf-into-the-fold/ [https://perma.cc/95DQ-QFCS].

43. *Id.*

44. *Id.*

45. Colvin, *supra* note 2.

46. *Id.*

47. *Id.*

48. *Id.* By 2017, when it became clear that management's strategy had failed, Trian began to take a more critical role, demanding a board seat and pushing for new management. *Id.* Even the "good" bloc holders can be proven to be incorrect *ex post*.

49. *See supra* notes 1–11 and accompanying text.

50. Nathan Vardi, *ValueAct Hedge Fund's Huge Microsoft Victory*, FORBES (Sept. 3, 2013, 8:00 AM), https://www.forbes.com/sites/nathanvardi/2013/09/03/valueact-hedge-funds-huge-microsoft-victory/?sh=4f48d74f18ae [https://perma.cc/F9S4-2QYZ].

invitation, ValueAct had been in discussions with other shareholders about launching a proxy contest in order to push for major strategic and operational changes at the company.[51] Rather than take on the fight, Microsoft instead secured a cooperation agreement with ValueAct that entitled the fund to place a director on the company's board.[52] In exchange, ValueAct agreed not to pursue a proxy contest or disparage the Microsoft executive team.[53] Indeed, the press release announcing the cooperation agreement between Microsoft and ValueAct revealed that ValueAct had been converted into a supporter; the fund indicated that "Microsoft is a world-class company with tremendous long-term potential."[54] And as expected, this relationship saved Microsoft from undergoing a disruptive proxy contest.[55]

Both *ex ante* and *ex post* forms of validation capital can serve a beneficial function. When validation capital is used virtuously, the provider of validation capital benefits the company and its shareholders by protecting a value-creating management team from disruption. The bloc holder also benefits from the increase in share value relative to the alternative price that would manifest if the market was concerned with the possibility that management might be forced off the right path.

Validation capital can, however, constitute corrupt relational investing.[56] Suppose an underperforming management team is threatened by a group of investors promising to wage a proxy fight. If management can find a "bodyguard"—a bloc holder that will support its plans—they may secure protection and further entrench themselves despite the fact that the alternative direction would result in higher firm value. Of course, a bloc holder will not vouch for a poorly performing management team for free: doing so will depress the value of the company's stock and cause the bloc holder to sustain losses on their bloc of shares. The bloc holder may also tarnish its reputation, risking future interventions. Therefore, the bloc holder will require a side

51. *Id.*

52. Microsoft Corp. & ValueAct Grp., Cooperation Agreement (Aug. 28, 2013), https://www.sec.gov/Archives/edgar/data/789019/000119312513354149/d592198dex991.htm [https://perma.cc/Y9AA-SQBY].

53. *Id.*

54. Press Release, Microsoft, Microsoft and ValueAct Capital Sign Cooperation Agreement (Aug. 30, 2013), https://news.microsoft.com/2013/08/30/microsoft-and-valueact-capital-sign-cooperation-agreement/ [https://perma.cc/K9RW-7G7T].

55. Vardi, *supra* note 50. This example further reveals that the provider of validation capital may initially target the company and its management; when a hostile or skeptical investor is converted into a supporter, this transformation sends a signal to the market. However, such a transformation may also be present when validation capital is being used corruptly, with a side payment serving as a form of "greenmail."

56. Although our Article describes the difference between corrupt and virtuous validation capital in binary terms, in reality, some cases will be less clear cut. For example, some situations involving a fund's protection may look corrupt in hindsight, but *ex ante*, the fund truly believed that management's vision was the right one for the company.

payment to offset its expected losses. Any such side payment can be paid upon the bloc holder's entry (for example, management can use a private placement to issue sweetheart shares to the bodyguard) or exit (for example, management can pay "greenmail" by buying back a dissenting bloc holder's shares at a premium).[57]

The existence of a side payment is a prerequisite for the corrupt form of validation capital; however, virtuous relational investing may also feature side payments. Consider once again Warren Buffett, who has a reputation of supplying the beneficial form of validation capital and who sometimes commands a sweetheart deal as an inducement for his investing in a company.[58] In such a situation, the bloc holder benefits not only from the increase in value of its shares but also from the side payment, which allows it to extract more rents from its actions. Therefore, the existence of a side payment does not establish corruption per se; however, a side payment is a necessary precondition for corruption.

Although examples of corrupt relational investing are rare, they exist. A classic example is that of Corporate Partners, which was set up as a "protection fund" in the early 1980s.[59] When Polaroid was targeted by hostile acquirers a few years later, the company sought an investment from Corporate Partners and ultimately gave the fund a sweetheart deal: in addition to a special warrant, the company issued two special series of preferred stock representing 10% of the company's votes—a total package that proved to be much more valuable than that received by other investors.[60] However, the company's decision to secure this *ex post* validation capital ultimately led to

---

57. MARK GERSTEIN, BRADLEY FARIS, TIMOTHY FITZSIMONS & JOHN NEWELL, LATHAM & WATKINS LLP, HUSHMAIL: ARE ACTIVIST HEDGE FUNDS BREAKING BAD? 2 (2014), https://www.lw.com/thoughtLeadership/lw-activist-investors-hushmail [https://perma.cc/B5CR-TMH7].

58. *See supra* note 38 and accompanying text. As just one example, consider how Buffett invested in Goldman Sachs under preferential terms during the financial crisis. In particular, Buffett's package of preferred stock and warrants netted Berkshire Hathaway $3 billion in the subsequent years. But Goldman Sachs got something too—Lloyd Blankfein, Goldman's CEO, said in a statement that the investment was a "strong validation" of the bank's business prospects. Kathy Chu, *Buffett Swoops in, Buys a $5B Stake in Goldman Sachs*, USA TODAY (Sept. 23, 2008), https://abcnews.go.com/Business/story?id=5871698&page=1 [https://perma.cc/VGB4-5WWQ].

59. Shamrock Holdings, Inc. v. Polaroid Corp., 709 F. Supp. 1311, 1326 (D. Del. 1989). Referring to Corporate Partners as a "friend to management," the court explained:

> In a descriptive brochure . . . furnished to Polaroid . . . , Corporate Partners described itself as an investment partnership "organized to make friendly investments, usually by taking large minority equity positions of approximately 10% to 30% in publicly held companies which could benefit from the presence of a large supportive shareholder. . . ." Corporate Partners further promoted itself in the same document as: "able to provide insulation from market operators and hostile acquirors . . . ."

*Id.*

60. *See* Rock, *supra* note 13, at 991–92 (describing the two special series of preferred Polaroid stock issued to Corporate Partners).

litigation in the Delaware Court of Chancery.[61] Although the court was troubled by the circumstances, it ultimately declined to enjoin the preferred stock sale under *Unocal*,[62] citing the arms-length negotiations between the company and fund as evidence of reasonableness.[63]

A more recent example of the potentially corrupt form of validation capital involved Barclays bank, which secured a large investment from the Qatar Investment Authorities that helped it avoid investor and regulator scrutiny in 2008.[64] The bank's failure to disclose that it also paid QIA hefty above-market investment fees in order to induce the fund's support led to a government investigation and eventual prosecution several years later.[65]

As a number of the examples discussed above illustrate, firms are sometimes targeted by multiple activist hedge funds. When this happens, a firm has an incentive to play one activist off against the others as it decides which activist should be invited inside the tent. This competition has, as we will see below, ambiguous effects. On the one hand, it will tend to reduce the cost to the firm of the provision of virtuous validation capital, to the benefit of the other shareholders. On the other hand, the competition, in principle, may be to provide corrupt validation capital. In light of this, to the extent that investors compete to be the management-favored bloc holder, the credibility of the virtuous validation capital signal may be reduced.

Quite obviously, the corrupt form of validation capital can be socially harmful: if the bodyguard protects underperforming management and allows it to continue down an inefficient path, shareholders will suffer losses and capital may be misallocated. But how common is the corrupt form of validation capital? What forms could side payments take? Before turning to our empirical study, we first explore the legal and market constraints that limit the potential for corruption.

## *B. Legal Framework*

Delaware law offers investors few protections against corrupt relational investing. In general, the board's decision to give a bloc holder preferential treatment upon entry (for example, by issuing discounted shares) would be protected by the business judgment rule.[66] However, extreme circumstances

61. Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989).

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

63. *Polaroid*, 559 A.2d at 290–91.

64. *Barclays Bosses 'Paid Qatar Secret Fees'*, BBC NEWS (Jan. 23, 2019), https://www.bbc.com/news/business-46979564 [https://perma.cc/7JHL-XLU6].

65. *Id.*

66. Rock, *supra* note 13, at 1006 (citing Bodell v. Gen. Gas & Elec. Corp., 140 A. 264, 268 (Del. 1927); and then citing 1 DAVID A. DREXLER, LEWIS S. BLACK JR. & A. GILCHRIST SPARKS III, DELAWARE CORPORATION LAW AND PRACTICE ch. 17 (Matthew Bender)); *see*

could invite more searching judicial review. As the Corporate Partners example reveals, stock issued in response to a proxy fight, takeover attempt, or other threat to management's control would be reviewed under *Unocal* and would likely fail that test if the facts suggested that the primary purpose of the transaction was management entrenchment or shareholder disenfranchisement.[67] In addition, a shareholder challenging a side payment in the corrupt scenario could argue that it constituted corporate waste.[68]

Likewise, management's decision to pay "greenmail" or "hushmail" by buying out a dissident shareholder at a premium would be given business judgment protection unless the facts suggested that the transaction was in response to a perceived threat to management's control.[69] And even under *Unocal*, the transaction would likely survive absent extreme facts; the Delaware Supreme Court has deemed the repurchase of stock from an activist hedge fund at a premium, in response to a threat of creeping control or underpriced hostile tender offer, to be a sufficient threat to warrant that response.[70]

However, it is possible that extreme circumstances could lead to liability not only for the board but also for the activist shareholder. For example, in *In re PLX Technology Inc. Stockholders Litigation*,[71] the Delaware Court of Chancery determined that the actions of an activist stockholder aided and abetted the defendant board of directors in a breach of its fiduciary duty when the company was sold.[72] Specifically, the activist shareholder who secured three board seats was deemed to have induced a breach of fiduciary duty by

---

Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988) ("[I]n the absence of evidence of fraud or unfairness, a corporation's repurchase of its capital stock at a premium over market from a dissident shareholder is entitled to the protection of the business judgment rule."); *see also* Kahn v. Roberts, 679 A.2d 460, 465 (Del. 1996) (holding that the board's decision to repurchase one-third of outstanding shares was protected under the business judgment rule in the absence of any threats to corporate control or conflicts of interest); Polk v. Good, 507 A.2d 531, 536–37 (Del. 1986) ("A Delaware corporation has the power to deal in its own stock and may acquire a dissident's shares provided the transaction is free from fraud or unfairness. . . . When properly accomplished, such matters are protected by the business judgment rule." (citations omitted)).

67. *See Perot*, 539 A.2d at 188 (characterizing the *Unocal* standard as an "enhanced duty of care" that is "triggered by a struggle for corporate control and the inherent presumption of director self-interest associated with such a contest"); Rock, *supra* note 13, at 990–93 (discussing *Polaroid*).

68. *See Feuer v. Redstone*, No. 12575–CB, 2018 WL 1870074, at *1 (Del. Ch. Apr. 19, 2018) (finding that a corporate waste claim alleging that millions of dollars were paid to an individual who could not provide services to the company survived a motion to dismiss).

69. *Perot*, 539 A.2d at 188–89.

70. *Polk*, 507 A.2d at 537.

71. No. 9880-VCL, 2018 WL 5018535 (Del. Ch. Oct. 16, 2018), *aff'd on other grounds*, 211 A.3d 137 (Del. 2019).

72. *Id.* at *2.

the rest of the board by pushing for a quick sale of the company.[73] Particularly relevant to the court was the fact that the activist shareholder, in pushing for a short-term profit via a sale of the company, had a "divergent interest" from the other shareholders.[74] This case therefore provides a basis for believing that activist shareholders that secure board seats can be vulnerable to litigation, even when the board itself is insulated from liability. Ultimately, however, shareholders seeking to challenge corrupt relational investments would likely be disappointed.

Federal law, by contrast, offers more potent safeguards for investors, primarily in the form of mandated disclosure. Most basically, information about a side payment is material and therefore would need to be disclosed via an 8-K.[75] Likewise, the 8-K must disclose any new directors and the terms of their compensation, as well as the terms of any settlement with an activist investor.[76] In addition, the terms of stock issuances to bloc holders are required to be disclosed in a few different places. An investor who acquires a 5% stake must file a Schedule 13D, which requires disclosure of the amount of funds used to purchase the stake and the voting power accumulated by the investor.[77] Likewise, institutional investment managers with at least $100 million in assets under management must file a Form 13F each quarter that discloses their holdings.[78] Not only that, Section 16 of the Securities and Exchange Act requires 10% holders to disclose information about their ownership stake when the stake is acquired (Form 3), when there is a material

---

73. *Id.* at *47, *49–50; Gail Weinstein, Steven Epstein & Matthew V. Soran, *A Series of Avoidable Missteps: Fiduciary Breaches in Connection with the Sale of a Company*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 26, 2018), https://corpgov.law.harvard.edu/2018/11/26/a-series-of-avoidable-missteps-fiduciary-breaches-in-connection-with-the-sale-of-a-company/ [https://perma.cc/5TL9-FT66].

74. The court noted that, in general, a shareholder's large stake in the company "would be helpful . . . [in] undermin[ing] any concern about divergent interest" from the other shareholders. *In re PLX Tech.*, 2018 WL 5018535, at *41. However, in the case of "[a]ctivist hedge funds [who] are impatient shareholders, who look for value and want it realized in the near or intermediate term," the desire for quick profits can create a conflict between the fund and the other shareholders. *Id.* (first alteration in original) (quoting William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 682 (2010)). Note that this reasoning depends on an inefficient market; otherwise, any long-term damage to the company would be reflected in the company's immediate share price.

75. For example, a settlement agreement with an activist shareholder will generally be disclosed as an exhibit to the 8-K, and that agreement includes information about potential side payments, including whether the company agreed to buy the activist's shares (and the terms of the purchase), the compensation for any activist director, and the amount of reimbursement allowed for the activist's expenses.

76. U.S. SEC. & EXCH. COMM'N, FORM 8-K (2021) (Item 5.02: director compensation); *see id.* (Items 7.01–8.01: settlement); *see also* Regulation S-K, 17 C.F.R. § 229.402 (2020) (Item 402: executive compensation).

77. Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d–1(a) (2020); Schedule 13D, 17 C.F.R. § 240.13d–101 (2020).

78. 17 C.F.R. § 240.13f–1(a)(1) (2020).

change in their holdings (Form 4), and any time they transact in the company's stock (Form 5).[79] Among other things, these forms require disclosure of the amount of securities acquired and the price paid for them.[80]

By ensuring that the terms of any transaction with a bloc holder are disclosed to the public, federal law likely chills companies from offering side payments in some instances. In addition, Regulation FD goes even further by prohibiting management from selectively disclosing material information to favored investors as a side payment.[81] As this discussion indicates, however, the legal framework governing the corrupt form of validation capital only somewhat constrains it. However, market constraints may prove to be a more potent force for investor protection, especially when combined with mandatory disclosure of side payments.

### C. *Market Constraints*

In understanding the conditions for corrupt relational investing, in general, and corrupt validation capital, in particular, it is worth returning to the 1980s context and the example of Corporate Partners's business strategy. DGCL § 203, Delaware's "antitakeover" statute, prohibits a hostile bidder from engaging in any "business combination" with the target for three years unless it acquires 85% of the shares in the transaction that takes it over the 15% threshold.[82] In the market context of the 1980s, such a delay seriously interfered with tender offer financing, as well as with paying down acquisition indebtedness by selling assets of the target. In this context, the effect of § 203 was that, as a practical matter, a single, friendly bloc holder with a 10% stake or greater could go a long way towards blocking any hostile tender offer. Corporate Partners emerged to provide this "service."[83] As discussed at that time, even this sort of side payment runs into various problems. Will the friendly shareholder's protection be effective against other threats such as proxy contests? Will the friendly shareholder stay friendly? How much should you pay for the service?[84]

In the current environment, the challenges are even greater because such "unilateral" protection is no longer available. Now, when an activist and a management team cannot resolve a conflict over the future strategy of the firm, the activist can launch a "short slate" proxy contest that has the effect of presenting the choice to the shareholder body as a whole, and, effectively,

---

79. 17 C.F.R. § 240.16a–2 (2020); 17 C.F.R. § 249.103–105 (2020).

80. U.S. SEC. & EXCH. COMM'N, FORM 3 (2021); U.S. SEC. & EXCH. COMM'N, FORM 4 (2021); U.S. SEC. & EXCH. COMM'N, FORM 5 (2021).

81. 17 C.F.R. § 243.100 (2020). However, it is possible that Regulation FD does not perfectly constrain selective disclosure as a side payment.

82. DEL. CODE ANN. tit. 8, § 203 (West 2017).

83. Rock, *supra* note 13, at 990–93.

84. *Id.* at 990.

to the largest institutional investors.[85] When this occurs, the largest institutional investors independently examine the competing strategies and, by voting their shares, choose one or the other. Activists often succeed in convincing other shareholders to support their alternative strategy. In this context, a bloc holder's support for management will only be effective in shielding management's strategy if the sophisticated proxy stewardship teams at the largest institutional investors find the bloc holder's views credible and convincing.

Here we see the critical importance of disclosure of side payments. In evaluating the bloc holder's support for management's strategy, the proxy stewardship teams will try to figure out whether the bloc holder supports management because it believes that management's strategy is better than the alternative (i.e., virtuous validation capital), as well as whether that is, in fact, correct. Any evidence that the bloc holder's incentives diverge from those of the shareholders as a group—because of side payments of one sort or another—will undermine the bloc holder's credibility with this key constituency and make it less likely that the bloc holder's recommendation will be an effective shield. Indeed, disclosed side payments may even lead proxy stewardship groups to support the activist with an alternative strategy because, after all, if incumbent management needs to *pay* a bloc holder to support its strategy, that strategy is probably not very good. This, in turn, will make the payment of corrupt side payments even less likely: why pay some bloc holder on the side if doing so not only will not provide a shield but might actually undermine management's strategy?

In addition to these barriers to corrupt relational investing that emerge from current practice, some of the older problems re-emerge. Management, contemplating hiring a "bodyguard," will rationally be concerned about a bloc holder's defection.[86] This is an especially potent threat for large bloc holders who will bear substantial losses if their shielding depresses the value of the company's shares; for those investors, the incentive to later challenge

---

85. *See* Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1748 (2008) (observing that of the 140 proxy contests in the sample, most hedge funds "seek to elect a short slate of directors rather than seeking majority control of the board"); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013) (describing the activist shareholder's role as "increas[ing] the value of the vote held by the institutions by teeing up the intervention choices at low cost to the institutional owners"); Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1776–77 (2020) (noting the ability of activist hedge funds concerned by performance issues to wage a proxy contest that attracts the attention of large institutional investors).

86. *See* Rock, *supra* note 13, at 1028 (noting a bloc holder's difficulty in credibly committing to protect management when "payment is . . . up front, while the threat of defection comes later").

management or exit the investment is substantial.[87] Indeed, this risk is part of what makes the bloc holder's support so credible. And in most instances, there is little to prevent the bloc holder from abandoning management and supporting a different strategy that would offer higher gains.[88] Although the bloc holder may enter into a standstill agreement with the company in which it promises not to wage a proxy fight or launch a takeover bid for a certain period of time, it will be free to support other shareholders who contest management's plans. Perhaps the company can secure a shareholders' agreement that commits the bodyguard to vote for management candidates; but even in this case, there is nothing to prevent the bodyguard from advertising its misgivings rather than validating management's plans.[89]

What about the bloc holder who is offered a side payment to protect an underperforming management team? An additional market mechanism will constrain investors from serving corruptly: reputation.[90] If an activist hedge fund serves corruptly and the market learns about it, that will undermine the effectiveness of the intervention (as discussed above) and will also compromise *future* interventions by the fund—virtuous and corrupt alike.[91] Given that bloc holders in general, and hedge fund activists in particular, require the support of other investors for their engagements to succeed,[92] a reputation for corruption will be very costly. When the activist fund's

87. Note that a large bloc holder will be somewhat constrained from exiting because their selling will depress the company's share price, but this limitation makes it even more likely that they will defect by challenging management and supporting a higher value strategy in the future.

88. This occurred with Trian and GE; Trian eventually challenged management when it was clear that they were underperforming. *See supra* note 48 and accompanying text.

89. The enforceability of a "corrupt" shareholders' agreement to support management may be questionable. In some circumstances, it may be viewed as illicit "vote-buying." Schreiber v. Carney, 447 A.2d 17, 25–26 (Del. Ch. 1982); *see generally* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296 (2016) (discussing the role of top shareholder activists in initiating proxy fights and replacing board members).

90. *See* Travis L. Johnson & Nathan Swem, *Reputation and Investor Activism: A Structural Approach*, 139 J. FIN. ECON. 29, 30 (2021) ("Activists . . . have an added incentive to initiate campaigns and proxy fights, even when they are not profitable in a single campaign, as an investment in reputation."); *cf.* Krishnan et al., *supra* note 89, at 297 (explaining why the top activist investors are those who "acquire a reputation for having the ability to pressure managers in *credible* ways" (emphasis added)).

91. Of course, if a fund plans to exit the market for shareholder activism, and this information is not known to other market participants, then the fund will be less concerned about its reputation; for that reason, we expect that hedge funds that look as though they underperform *ex post* would be the most interested in securing side payments. But as discussed, these funds will be less capable of generating a persuasive market signal.

92. Alon Brav, Wei Jiang, Tao Li & James Pinnington, *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 3 (European Corp. Governance Inst. Working Paper Series in Fin., Working Paper No. 601/2019, 2020), http://ssrn.com/abstract_id=3101473 [https://perma.cc/SC58-BBSW] (noting that "firms are targeted presumably because an activist anticipates high voting support from a friendly shareholder base due to circumstances such as firm underperformance, or to inherent shareholder stance toward activism").

reputation is at stake, one would expect the fund to demand a very large side payment—one that compensates it not only for its investment losses in the given firm but also in any future campaign that it might wage.[93]

The extent of damage to a bloc holder's reputation, however, depends on the degree of uncertainty regarding the correct plan for the firm. After all, it is the ambiguity about management's strategy that is the driving force behind both the corrupt and virtuous forms of validation capital. If the market cannot ascertain whether the management team is being protected for virtuous or corrupt reasons, the market will be slow to downgrade its beliefs about the bloc holder's reputation. Therefore, the higher the uncertainty about the correct course of action, the lower the side payment necessary to compensate for reputational damage.

But other factors suggest that the necessary side payment would be substantial. For example, a management team that seeks validation capital *ex ante*, prior to the arrival of dissatisfied shareholders, would need to offer a side payment that compensates the activist for expected losses for the duration of the investment, which could be several years. In addition, if the payment is in the form of traded securities, these need to be sold in the market upon exit, so higher illiquidity ought to lead to a higher discount upfront. Similarly, higher firm volatility should also lead to a higher payment since the bodyguard may not be fully diversified. Finally, if the activist holds a large bloc of shares (and one that was accumulated on the open market), its future losses could be substantial. In such a case, the prospect of defection also looms large.

When we aggregate these factors, the range of potential agreement between management and a would-be corrupt relational investor will be very narrow or non-existent. On the management side, the management team will want assurance that the bloc holder will be able to "deliver the goods" and will discount the amount it is willing to pay to reflect uncertainty. On the bloc holder side, the risks—reputational and otherwise—are large, and the bloc holder will want to be compensated for those risks. Finally, any side payment will have to be disclosed and may itself undermine the degree of protection by signaling weakness. The more overtly corrupt the appointment, the less likely that the investment will be worthwhile. In addition, the reputable funds that are most able to validate management's plans are also the least likely to be willing to serve in this role, as the size of the side payment necessary to induce the fund to act corruptly would likely be prohibitively large. These reputable funds may also be perceived by management as the most likely to

93. By contrast, in the 1980s, the reputational dynamic potentially worked differently. To the extent that Corporate Partners developed a reputation for supporting management, this made them more reliable management partners in the future. But this was only because, at that time, Corporate Partners could offer unilateral protection and did not need to convince other investors of the merits of management's strategy. *See supra* notes 83–84 and accompanying text.

defect down the road. This is not to suggest that corrupt relational investing is impossible, only that we expect that it is rare, especially among experienced hedge fund activists that regularly launch campaigns. And as the next section reveals, this is what our empirical study suggests.

## II. Empirical Study: Side Payments to Hedge Fund Activists

We gathered data about every activism event involving a hedge fund for the year 2015 from FactSet's Shark Repellent. This data includes all potential validation capital events involving hedge funds and public companies in the U.S. from that year, although it is likely to be over-inclusive—i.e., some of the events that we observe are simply activist engagements with the goal of disrupting the company rather than activist stake accumulation for the purpose of shielding the company.

The sample includes a total of 279 events; we examined each for evidence of corruption—i.e., large side payments made to activist hedge funds who accumulate stakes in companies.[94] For each activist engagement, we searched the SEC's EDGAR website for relevant filings, including Schedule 13Ds filed by the activist and any amendments, Form 8-Ks, and forms required to be filed under Rule 16(a). We also searched news articles for information about side payments. In our searches, we flagged whether the activist's stake was purchased on the open market, whether the activist received reimbursement or differential director compensation, or whether there was any other potential side payment (such as a share repurchase).

Our results are summarized in the Table below. Panel A provides the breakdown of events for which we can verify that all of the activist's shares were purchased on the open market whereas Panel B provides information for events in which activists did not acquire their entire stake on the open market. For each panel we further provide a breakdown into finer categories capturing different transactions via which managements might provide a side payment to the activist. These categories are (i) repurchases, (ii) differential director(s) pay, (iii) reimbursement to the activist, and (iv) other forms of potential side payments. Additional details regarding potential side payments are provided in the "comments" column.

As Panel A indicates, the majority of these events (163 or 58.42%) did not involve any potential side payments—all shares were purchased on the

94. As discussed, evidence of side payments is a necessary condition for the corrupt version of validation capital. We do not investigate whether the activist events actually provided validation capital, i.e., whether they shielded the company from becoming a target in the future. We simply seek to determine whether side payments indicative of corruption were taking place. In addition, because we do not find evidence of substantial side payments, we do not address whether the side payments plausibly represented the bad or good form of validation capital. As the Buffett examples reveal, side payments may be used to induce the virtuous form of validation capital. *See supra* note 38 and accompanying text.

open market, and there was no repurchasing of shares, reimbursement of fund expenses, or differential pay. For thirty-two events, comprising 11.47% of the sample, we were unable to determine whether the activist's stake was purchased on the open market or whether there was a potential side payment. For almost all of these events, the activist shareholder was not a 5% holder and therefore was not required to file a 13D.

The remaining sample of eighty-four events, or roughly 30% of the sample, involved potential side payments. In twenty of those events (shown in the last three rows of Panel A), the activist accumulated its stake on the open market, but there were other side payments. However, we are not especially concerned about these events: a side payment must be especially large to induce corruption when the activist accumulates its stake on the open market, and the side payments we observed were generally small. For example, seventeen of the events involved reimbursement of activist expenses, but the total was capped at a low amount—on average, only $265,667.[95] Two of the events involved a company's promise to repurchase the fund's shares at a pre-specified price, but we were not able to ascertain whether the price was above market. And one example involved a secondary equity offering by the fund in which the company agreed not to sell any shares. In total, these examples did not appear particularly indicative of corruption.

In sixty-four instances (or 22.94%) the activist fund did not accumulate its stake solely via open market purchases. These events are documented in Panel B, and many featured an additional opportunity for a side payment, such as expense reimbursement, differential pay for the activist director(s), a promise to repurchase shares, consulting fees, a private placement of shares, notes or warrants, and warrant amendments. However, when we examined these examples, we did not find clear evidence of corruption; indeed, the majority appeared innocuous. For example, in twelve instances, the fund's non-market stake was accumulated via director compensation, but there was no indication that the compensation was different than that paid to the other directors.[96] There were five additional instances in which the fund's non-market stake was accumulated via director compensation; although we could not ascertain that the fund directors were given the same consideration as the company's other directors, the terms of their compensation did not appear

95. Two campaigns featured a promise to reimburse expenses that was uncapped (the campaign at Capital Senior Living Corp. and the campaign at Hill International); however, one of those promises to reimburse expenses was secured pursuant to a court order, again indicating that corruption was not the motive. Cap. Senior Living Corp. & Lucus Grp., *Form 8-K Exhibit 99.1: Agreement* (Mar. 21, 2016), https://fintel.io/doc/sec-csu-8k-capital-senior-living-2016-march-21-18375 [https://perma.cc/U9HV-D35R]; Hill Int'l, Inc., *Form 8-K* (Sept. 15, 2016), https://ir.hillintl.com/node/20731/html [https://perma.cc/K9GP-KPSJ].

96. In three of these events, the hedge fund eventually acquired the targeted company.

substantial enough to induce corruption given that the remainder of the stake was accumulated via open market purchases.[97] Two instances involved the company's promise to pay consulting fees for the activist director; however, these events were not good candidates for corruption, as one provided only the same compensation as was given to other directors and the other capped the amount of money available for consulting fees at $5,000. The fifteen events that involved promises to reimburse the activist's expenses likewise capped the totals at small amounts, averaging only $84,583.

The remaining thirty instances did not turn up clear evidence of corruption, although we need more information to be certain. These events included one promise to amend warrants and issue additional warrants; twenty-two private placements, direct offerings, or subscription offerings; four events that featured both private placements and notes; two events that featured only notes; and one repurchase that also featured expense reimbursement of $45,000.

**Table**: Sample of 279 Activism Events for the Year 2015

Panel A: All shares purchased on the open market (*N* = 183, 65.59%)

| Transactions generating potential side payment: | | | Comments: |
|---|---|---|---|
| Repurchases? | No | *N* = 163<br>58.42% | |
| Differential directors' pay? | No | | |
| Reimbursement? | No | | |
| Other potential side payment? | No | | |
| Repurchases? | Yes | *N* = 2<br>0.72% | |
| Differential directors' pay? | No | | |
| Reimbursement? | No | | |
| Other potential side payment? | No | | |
| Repurchases? | No | *N* = 17<br>6.09% | |
| Differential directors' pay? | No | | |
| Reimbursement? | Yes | | |
| Other potential side payment? | No | | |
| Repurchases? | No | *N* = 1<br>0.36% | • Secondary equity offering |
| Differential directors' pay? | No | | |
| Reimbursement? | No | | |
| Other potential side payment? | Yes | | |

97. For example, in the campaign at Magnetek, the hedge fund director was given an option to acquire 2,000 company shares at an exercise price of $38.51 per share and did not indicate that this consideration was the same as was awarded to other directors. But even if this consideration was different, the total size of the side payment is likely insufficient to induce corruption. Kyle Cerminara, *Form 4: Statement of Changes in Beneficial Ownership* (May 4, 2015), https://www.sec.gov/Archives/edgar/data/751085/000114036115017295/xslF345X03/doc1.xml [https://perma.cc/27CK-8B9L].

Panel B: Not all shares purchased on the open market ($N$ = 64, 22.94%)

| Transactions generating potential side payment: | | | Comments: |
|---|---|---|---|
| Repurchases? | No | $N$ = 12<br>4.30% | • Non-market share purchase is the non-differential director's pay ($N$ = 9, 3.23%)<br>• Non-market share purchase is the non-differential director's pay AND the hedge fund acquired the target company ($N$ = 3, 1.08%) |
| Differential directors' pay? | No | | |
| Reimbursement? | No | | |
| Other potential side payment? | No | | |
| Repurchases? | No | $N$ = 15<br>5.38% | |
| Differential directors' pay? | No | | |
| Reimbursement? | Yes | | |
| Other potential side payment? | No | | |
| Repurchases? | Yes | $N$ = 1<br>0.36% | |
| Differential directors' pay? | No | | |
| Reimbursement? | Yes | | |
| Other potential side payment? | No | | |
| Repurchases? | No | $N$ = 5<br>1.79% | |
| Differential directors' pay? | Yes | | |
| Reimbursement? | No | | |
| Other potential side payment? | No | | |
| Repurchases? | No | $N$ = 27<br>9.68% | • Private Placement/ Subscription offering/Private transaction/Direct offering, including common shares, preferred shares, warrants ($N$ = 21, 7.52%)<br>• Notes, including convertible notes, senior secured notes, as well as private placement/ Subscription offering/Private transaction/Direct offering, including common shares, preferred shares, warrants ($N$ = 3, 1.07%)<br>• Notes, including convertible notes, senior secured notes ($N$ = 2, 0.72%)<br>• Consulting/Advisor compensation ($N$ = 1, 0.36%) |
| Differential directors' pay? | No | | |
| Reimbursement? | No | | |
| Other potential side payment? | Yes | | |

| Repurchases? | No | $N = 4$<br>1.43% | • Amendments of warrants requirements; Additional warrant issuance ($N = 1$, 0.36%)<br>• Private Placement/ Subscription offering/Private transaction/Direct offering, including common shares, preferred shares, warrants ($N = 1$, 0.36%)<br>• Notes, including convertible notes, senior secured notes, as well as private placement/ Subscription offering/Private transaction/Direct offering, including common shares, preferred shares, warrants ($N = 1$, 0.36%)<br>• Consulting/Advisor compensation ($N = 1$, 0.36%) |
|---|---|---|---|
| Differential directors' pay? | No | | |
| Reimbursement? | Yes | | |
| Other potential side payment? | Yes | | |

In sum, for this sample of events we did not find evidence of substantial side payments, suggesting that the corrupt form of validation capital provided by hedge funds at U.S. public companies is sufficiently constrained by market and legal forces. And this is so despite the fact that our data revealed that side payments are relatively common. In other words, opportunities for corruption abound, and yet management and activist funds seem not to be taking them. That is not to say that the corrupt form of validation capital never takes place, but in most instances legal and market forces appear to protect public company investors from this form of corruption.

## III. Implications and Open Questions

We conclude with implications of our analysis for investors and policymakers, as well as open questions. To begin, we reiterate that public company investors should be comforted by our analysis; our study did not turn up any evidence of the corrupt form of validation capital at public companies during a period in which activist hedge funds were particularly active. However, investors should be concerned whenever a company discloses large side payments to a fund, and as our analysis reveals, they can take many forms. In addition, as the Barclays example indicates, management may sometimes hide side payments from investors in order to

shield the investment from scrutiny.[98] Hidden side payments are especially concerning, and investors should be wary of them.

This discussion previews our implications for lawmakers: although disclosure requirements appear to be aptly chilling corrupt validation capital, there are limits to the reach of disclosure. In particular, a fund that accumulates a stake that is less than 5% will not be required to file a 13D.[99] Investors rarely cross this threshold in large cap firms, although there may be other market forces that limit corrupt relational investing at these companies (such as monitoring by banks, analysts, and institutional investors). Although information about a private placement or other large side payment to an investor would be required to be disclosed in an 8-K, it is possible that a company could hide these payments under the theory that they were not sufficiently material to warrant supplemental disclosure. Even if the SEC disagrees, it is not likely to bring an enforcement action. Therefore, regulators could benefit investors by emphasizing that side payments to investors are material and require disclosure and by also bringing enforcement actions whenever large side payments are not disclosed.

Likewise, our study did not address whether other types of funds are able to command side payments in exchange for serving corruptly. Although we anticipate that such side payments would be similarly rare, recall that in the Barclay's example, the recipient of the side payment was a reputable sovereign wealth fund; therefore, investors should be on the lookout for side payments to funds of all types.

We also raise open questions that future research should explore to better understand the phenomenon of validation capital. For one, our study did not address the prevalence of the phenomenon—i.e., whether companies regularly use validation capital—or the circumstances under which validation capital is most effective. Future research could explore when and how management and investors team up to chill future interventions by dissident shareholders. For public companies, we suspect that the virtuous form of validation capital will be as rare as the corrupt form given the limitations we discuss in subpart I(C) and the difficulties in contracting and the ambiguity of market signals in particular. In addition, management of undervalued companies may instead take the company private rather than bring an activist director on board. For private companies, which our study did not include, we expect that the corrupt form would be particularly rare given that most private companies feature insider bloc holders. Nonetheless, the virtuous form of validation capital could be more common at private companies than public ones if investors view the presence of a sophisticated investor as a particularly helpful signal when evaluating an early-stage company.

---

98. *See supra* note 64 and accompanying text.

99. Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d–1 (2020).

In addition, our analysis did not explore a variation of validation capital that is used to resolve intra-corporate disputes. For example, a CEO that is in danger of being fired by the company's board of directors can entice an investment from a supportive investor in an attempt to keep their job. Likewise, a board of directors can entice an investment from an investor that will help them in their battle with the CEO.[100] In other words, while our analysis suggested that management is often aligned, this may not always be the case.

## Conclusion

Our Article explored the phenomenon of validation capital, whereby bloc holders shield management from shareholder interference by vetting and then vouching for the company's pre-existing strategy. We described how validation capital can benefit companies and their shareholders by addressing information asymmetries that might lead outside investors to misjudge management's quality. We also explored how validation capital can be harmful when ineffective management teams offer side payments to investors in exchange for their protection. Although corruption of this kind is possible, we argue that legal and market mechanisms do much to constrain it. And our empirical study of hedge fund activism events from 2015 generally supported this hypothesis: although side payments are relatively common, they tend to be small and not of the magnitude necessary to induce corruption. Therefore, the legal regime governing disclosure and external market forces appear to be adequately protecting investors, at least when it comes to side payments made to activist hedge funds at U.S. public companies.

100. For example, the Papa John's International Inc. board secured a large investment from the hedge fund Starboard Value LP and awarded the fund two board seats during its dispute with former CEO and large shareholder John Schnatter; ultimately, Starboard's participation helped the company resolve litigation with Schnatter. Julie Jargon, *Papa John's Founder John Schnatter to Leave Board*, WALL ST. J. (Mar. 5, 2019, 8:13 AM), https://www.wsj.com/articles/papa-johns-founder-john-schnatter-to-leave-board-11551787717 [https://perma.cc/Z9LK-P7RE].