The Wolf at the Door: Developments in Hedge Fund Activism, Federal Securities Litigation, and Delaware Corporate Governance

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Part I: The Rising Pace of Hedge Fund Activism

1. The phenomena of “activist” hedge funds buying stock in targets specifically to propose changes in business policies appears to date from around 2005 (Briggs 2007). With this transition, shareholder activism moved from the defense (i.e., resisting management proposals and compensation) to the offense (seeking restructurings, buybacks, special dividends, and sales of the company).
2. Over a 20 month period from 2005-2006, the first study counted 52 such campaigns (Briggs)
3. The period from 2010 to early 2014 witnessed 1,115 “activist” campaigns.
4. 2014 saw a record 347 “activist” campaigns (FactSet Shark Watch)—up from 209 in 2009.
5. At this rate, the majority of exchange-listed corporations could experience an activist campaign within another three to five years. But: there is a special profile to targets: a low Tobin’s Q and unrelated divisions that make possible “negative synergy.”

What Explains the Rise of Hedge Fund Activism?

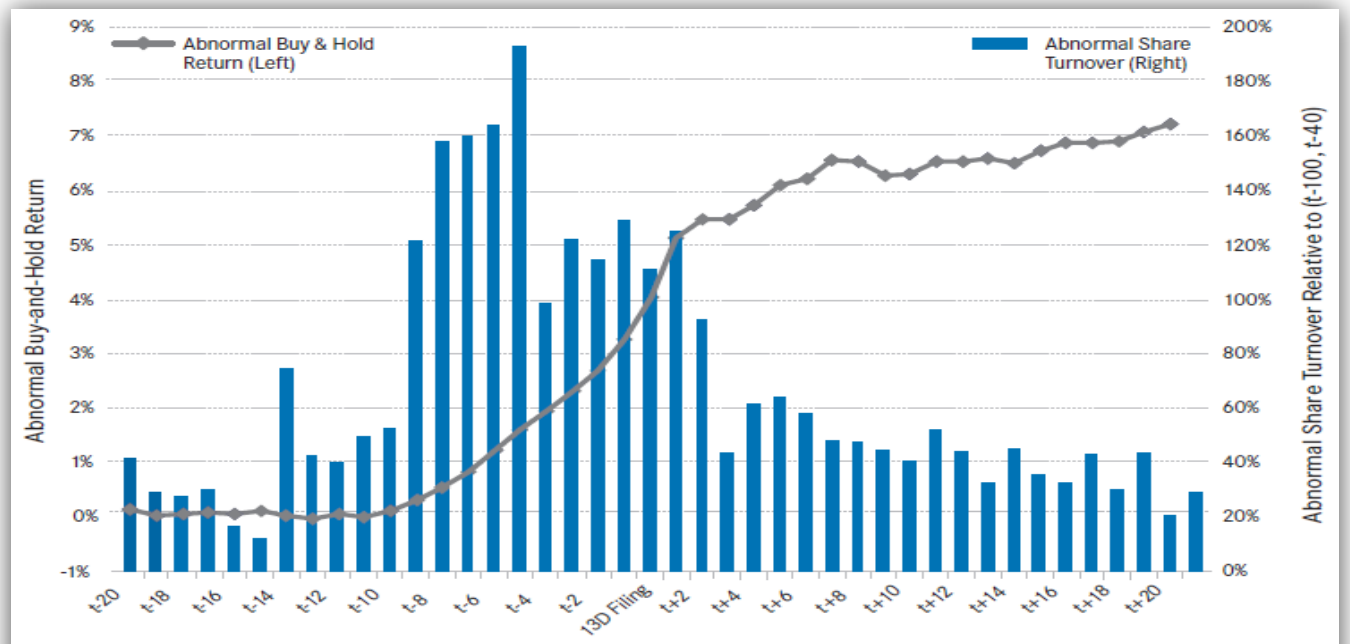
1. Costs are down (deregulation)
2. Structural changes have also helped (decline of staggered boards, increased influence of proxy advisors, proxy access, etc.)
3. Key Business Model Decision: Some Hedge Funds Decided They Could Not Regularly Beat the Efficient Market as Superior Stock Pickers. So, They Shifted to Investing in Underperforming Companies to Transform Them (or Break Them Up).
4. Profits are up ("activist" hedge funds are averaging a 13% return over the last ten years—more than double the 5.8% return for all hedge funds).
5. Correspondingly, the assets managed by "activist" funds have soared, growing from $23 billion in 2002 to $166 billion in $2014. The top ten "activist" funds alone attracted $30 billion in 2013.
6. Best yet, a short-term gain on the filing of the Schedule 13D is relatively certain, with the abnormal gain averaging 6 to 7% across all studies (and more if a "wolf pack" is involved).
7. Bottom line: Costs Down, Profit Up, Gain is Relatively Riskless—But a Bubble could be developing as more and more activists chase fewer and fewer obvious targets.

How Successful is Proxy Activism?

1. Several recent studies place the "success" rate in proxy fights for activists at just over 75%
2. The actual number of proxy contests has declined—as managements have learned that it is better to settle than to fight (as even Martin Lipton concedes).
3. Revealingly, at those companies where activists win even <u>one</u> seat on the board, the CEO leaves within 18 months in 44% of the cases (for example, Sothebys).

One New Tactic Probably Best Explains Activists' Success in Proxy Contest—The Wolf Pack

1. The "Wolf Pack" is a loose association of hedge funds (and some other institutions) that carefully avoid forming a "group" for purposes of §13(d)(3) of the Williams Act, but share a common goal and often have advance knowledge of the impending filing of a Schedule 13D by the wolf pack's leader.
2. Those forming the "wolf pack" can tip prospective allies of their plans because no fiduciary breach is involved (rather, their own institution's interests are furthered); thus, this use of material, non-public information does not amount to insider trading. Norms of reciprocity may develop: "You tip me, and I will tip you."
3. The following diagram illustrates the characteristic pattern and shows the amount of abnormal trading during the ten day window preceding the Schedule 13D filing:



Source: Alon Brav, Wei Jiang, Frank Partnoy and Randall S. Thomas, "Hedge Fund Activism, Corporate Governance, and Firm Performance," *Journal of Finance*, 63, no. 4, August 2008, p. 1756

1. The Wolf Pack Has Altered Prior Practice, and the Resulting Balance of Advantage in the Following Respects:

A. The Wolf Pack Acquires a Larger Stake: 13.4% as compared to 8.3% by other activists (See Becht, Franks, Grant and Wagner). And This May Understate, Because Silent Allies Need Not Disclose

B. The announcements of a "wolf pack" engagement produces more than twice as high an abnormal market return (14% to 6% for other activists—Becht, Franks, Grant and Wagner).

C. The probability of a "wolf pack" achieving at least one of its intended goals is much higher (78% versus 46% for other activists).

2. As money flows into activist hedge funds, these disparities seem likely to increase, as larger stakes can be acquired.

3. How much can a wolf pack acquire? In the Sotheby's litigation, proxy solicitors testified that hedge funds then held an estimated 32% of Sotheby's.

What Are The Impacts of Hedge Fund Activism?

Outstanding Issues in Empirical Papers

- Short-term abnormal return event studies
  1. Distribution of Returns: Approximately 25%-40% of the sample earn negative returns (e.g., 38% in Brav, Jiang, Partnoy & Thomas 2008)
  2. Disconnect: Positive abnormal returns not consistently related to agency cost proxies such as high free cash flow, overinvestment in capital expenditures, bad CEO or directors, governance problems, etc.
  3. Negative Synergy: Positive abnormal returns in many studies for firms selling some part of firm or entire firm (e.g., Khorana, et al. 2013)
  4. Wealth Transfers: Transfer of wealth from bondholders to shareholders (Klein and Zur 2011)
  5. Employee wages stagnate and no changes in hours worked (Brav, Jiang & Kim 2013)

Longer Term Studies: Basically, 2 Papers:

1. Bebchuk, Brav & Jiang (2015)(BBJ)
2. Becht, Franks, Grant & Wagner (2015)(BFGW)

BFGW

1. BFGW find that meaningful long term gains depend upon the realization of an outcome: either a takeover or a restructuring. If those outcomes not realized, gains erode.
2. Gains associated with liquidity events (special dividends or stock buybacks) are insignificant to even negative.
3. Gains associated with corporate governance changes are modest and appear to relate to changes in the expected takeover premium.
4. Our Interpretation: Hedge Fund Activism is paralleling bust-up takeovers of the 1980s, seeking to realize negative synergy.

BBJ

1. BBJ find that targets are like their industry/size/firm age counterparts after intervention but are undervalued before
2. 19% of BBJ's Sample Falls Into a Special Category They Define as "Investment-Limiting" Interventions.
3. They define "investment-limiting" to include the following:

   (i) the increase in leverage from the base year to any of the examined years falls within the top 5% of leverage increases among all public companies in that year; or

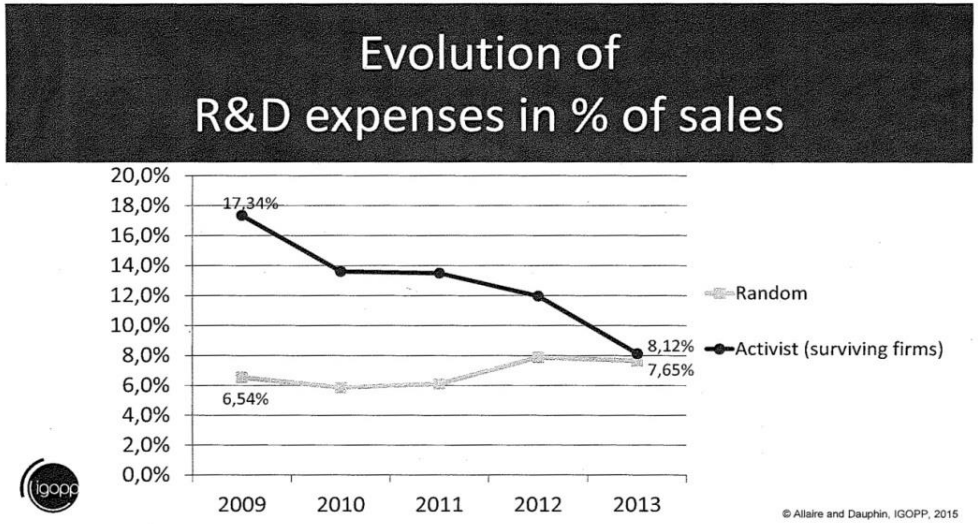
   (ii) the increase in payout yield (including dividends and share buybacks) from the base year to any of the examined years falls within the top 5% of payout increases among all public co's in that year; or

   iii) the increase in capital expenditure and R&D from the base year to any of the examined years falls within the bottom 5% of all firms in that year (hence decrease in investment in large magnitude). By "base year," we refer to the year-end before targeting, that is, year (t–1)

4. This narrow definition of "investment-limiting" suggests that if the criteria were relaxed modestly, an even higher percentage of hedge fund engagements would fall into this category.

The Impact on R&D

1. The BBJ View is that Corporate Managers Overinvest in Capital Expenditures and Research and Development. In this view, Hedge Fund Activism Corrects and Restores the Corporation to an "Optimal" Investment Policy.
2. But What Is the "Optimal" Policy? Overinvestment may occur, But Others Believe that Activism is Creating A Negative Externality by Excessively Curbing R&D.
3. For example, Allaire and Dauphin report, using the FactSet database, that in the four-year period following a hedge fund "engagement," R&D expenses at "surviving" target firms declines by more than 50% (expressed as a percentage of sales):



4. Moreover, their figure may understate the R&D decline, as it does not include the likely R&D decline at firms that are taken over.
5. Although all studies find that activist engagements produce significantly reduced R&D expenditures, proponents of activism retort that targeted firms increase their "innovation output," filing more patent applications thereafter than do firms in a matched sample. See Brav, Jiang, Ma and Tian, "Shareholder Power and Corporation Innovation: Evidence from Hedge Fund Activism" (2015). This "more for less" claim is contestable and depends upon the weight assigned to patent counts and patent citations.
6. Bottom line: Even if activism increases the probability of R&D expenditures, the reduction in total R&D expenditures should be of concern because R&D produces positive externalities. That is, other firms and society benefit from greater R&D investment because the firm conducting R&D does not capture all the benefits. Reduced R&D may be socially undesirable, even if it could be privately profitable.

Implications and The Broader Picture: Beyond the Hedge Funds

1. For better or worse, a revolution may be in progress within the public corporation, of which hedge fund activism is only the spearhead.
2. As a recent study by the Roosevelt Institute summarized:

   "In the 1960s, an additional dollar of earnings or borrowing was associated with about a 40-cent increase in investment. In recent years, the same dollar is associated with less than 10 cents of additional investment." See J.W. Mason, Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment (2015).
3. From the second half of 2009 through 2013, the Federal Reserve's Flow of Funds data shows that corporate investment increased by $400 billion, while shareholder payouts increased by $770 billion and corporate borrowing by nearly $900 billion. In effect, corporate borrowing is primarily funding shareholder payouts, not investment (Id.).
4. Hedge fund activism did not cause this imbalance, but it appears to be accelerating it.
5. Ultimately, the question becomes whether the public corporation in the 21st Century can fund R&D or even retain its capital. BBJ's assumption that activism is enforcing an "optimal investment policy" is undefended and needs closer examination.
6. Are institutional shareholders "greedy" (or characterized by "short-term" investment horizons), while individual and "indexed" shareholders (BlackRock, State Street, Vanguard) are "patient"? The former sought to break up DuPont, while the latter defended it. Why is this division so clear-cut? It may be that "stock picking" investors focus on the target firm, but more indexed investors focus on the more mixed impact of activism on their broader portfolio (including their debt investments). Or, activism that drives down long-term investment may be perceived to injure some corporate sectors disproportionately.

Policy Options

1. Shortening the 10-Day Window Under The Williams Act
   1. Under current law, a person (or group) that acquires 5% of a public company must file a Schedule 13D within 10 days thereafter.
   2. The Dodd-Frank Act in 2010 authorized the SEC to shorten this period, as they determined (In the U.K., the period is two business days).
   3. The business community has pushed hard for shortening the period to two business days; and the institutional investor community (and many academics) have resisted.
   4. The SEC has procrastinated and appears likely to continue to do so.
2. The Universal Proxy
   1. Today, two sides in a proxy contest circulate their own proxies, and insurgent hedge funds usually run a "short slate" of three or so directors (in the case of a ten (10) person board, the hedge fund would nominate 7 of the 10 incumbents and their own 3 nominees).
   2. But what happens if a shareholder wants to vote for only one insurgent and nine incumbents? Today, the shareholder cannot; it can vote for one insurgent and the seven incumbents on the hedge fund's slate, but the shareholder loses two votes and cannot vote for the incumbents not nominated by the insurgent.
   3. A "Universal Proxy" would list all thirteen nominees of all contestants and allow shareholders to pick and choose as they please.
   4. SEC Chair Mary Jo White has endorsed the "Universal Proxy."
3. Proxy Access
   1. "Proxy Access"—the ability of insurgents to place their nominees on the corporation's own proxy statement—appears also to be coming. Originally, the Dodd-Frank Act authorized the SEC to permit "proxy access", but the D.C. Circuit struck down the SEC's initial attempt for its flawed cost/benefit analysis. Now, private action may be introducing it, based on a template developed first by G.E. Under the G.E. model, shareholders holding 3% of the stock who have held for 3 years can add their nominees (up to three) to the corporation's nominees on the corporation's proxy statement. This will require hedge funds to find allies among indexed investors as hedge funds seldom have held for 3 years.

Part II: Developments in Securities Litigation.

1. A New Trend: Defendants Are Winning
   a) The Conventional Wisdom was that Securities Class Actions "Always" Settle.
   b) For the last several years, the reality is different. Cornerstone Research's 2014 study shows a shift beginning around 2008:

Year of Filing	Dismissed	Settled	Continuing
2007	42%	54%	4%
2008	51%	46%	3%
2009	51%	36%	13%
2010	59%	29%	11%
2011	58%	26%	16%
2012	40%	11%	49%
2013	11%	1%	88%
2014	8%	--	92%

← **Last Traditional Year**

   c) This shift does not mean extinction for plaintiffs' attorneys, as their fees average nearly 25% of the recovery on the cases that settle. But defendants are more inclined to fight in light of this data.

13. The Omnicare Decision

1. In Omnicare, Inc. v. Laborers District Counsel Construction Industry Pension Fund, 135 S. Ct. 1318 (2015), the Supreme Court this year framed a new standard for statements of opinions. Consistent with earlier cases, the case begins by stating a statement of opinion is not false or "untrue" simply because the opinion proves wrong. Under that standard, liability was possible only if the statement was not sincerely held (subjective falsity).
2. But the majority also held that whether a statement of opinion is misleading is an objective inquiry into how the reasonable person understood the statement, what facts it implied, and what knowledge the maker of the statement had.
3. In short, there can be "omissions" liability where the maker of the opinion statement omits to state material facts that are inconsistent with it.
4. On its facts, the defendant stated that: "We believe our contract arrangements with other healthcare providers…are in compliance with applicable federal law and state law." The Federal Government later prosecuted Omnicare for antitrust violations involving illegal rebates.
5. The Omnicare test seems to be: Did the opinion "fairly align with the information in the issuer's possession at that time?" If not, the omission of that information may be actionable if material.
6. Impact: There will still be a strong incentive to state facts as opinions by adding "We believe." But cautious practitioners will realize the need to also disclose the underlying assumptions and known inconsistent facts.
7. Uncertainty: Omnicare is a Section 11 case (a 1933 Act provision). Whether it leaks over and influences Rule 10b-5 case law remains to be seen (but is likely in my judgment).

III. What's New In Delaware?

A. Judicial Review of Mergers: Business Judgment or "Entire Fairness".

1. In Kahn v. M&F Worldwide Corp., 88 A. 3d 635 (Del. 2014), the Delaware Supreme Court held that a "going private" merger with a controlling shareholder was subject to a business judgment review (as opposed to the traditional and more rigorous "entire fairness" review) if the board followed a "dual protection merger structure."
2. This "dual protection merger structure" requires (1) approval of the transaction by an independent special committee of directors that has fulfilled its duty of care and that is fully empowered to hire advisers and reject the offer; and (2) an uncoerced and informed vote of a majority of the minority shareholders (i.e., those not affiliated with the controlling shareholder) to which vote the majority shareholder will be bound.
3. The "majority of the minority" requirement creates an incentive for holdouts. Suppose that there was a minority of 40%, composed largely of institutional investors (including activist hedge funds and arbitrageurs). If so, a minority of 20.01%, composed of these activists, can block everything if the corporation decides to elect this procedure. Activists allegedly do buy stock to defeat the offer and seek a revised bid.
4. Which route should the corporation elect? The "dual protection" path can lead to a minority veto by hedge funds and hold outs who are seeking an increased price. But if the board declines to take this route, it is subject to an "entire fairness" review with the burden on it to prove the fairness of the transaction (and litigation is inevitable in a U.S. merger).

B. Gatekeeper Liability

1. The potential liability of investment bankers has been significantly expanded by In re Rural Metro Corp. Shareholders Litigation, 88 A. 3d 54 (Del. Ch. 2014). Vice Chancellor Laster held an investment bank (the Royal Bank of Canada (RBC)) liable for monetary damages for aiding and abetting breaches of the duty of care by board members of the target company.
2. Although investment banks advising a board in a merger usually provide in their engagement agreement that they are not acting, as "fiduciaries," this exculpation does not preclude them from liability as "gatekeepers" who aid and abet the board's failure. RBC was retained by a special committee of the target that was being sold to a private equity firm. The Vice Chancellor particularly faulted RBC for its "full court press" to provide buy-side financing (which created a bias in favor of the transaction), a self-interested and "unreasonable" sale process, and RBC's creation of "information gaps" among the directors.
3. "Gatekeepers", the Vice Chancellor ruled, citing this author, are charged with "provid[ing] sound advice, monitor[ing] clients and deter[ing] client wrongs." As a result, investment bankers need to cause the board to fulfill its duties or face potential liability (while the board, itself, is ironically protected from due care liability by the standard §102(b)(7) exculpation provisions in most corporate charters).
4. Note the difference: a "fairness opinion" says only that the transaction is fair, not that it maximizes value for shareholders (which is probably the board's duty, but now has been extended to the investment banker).
5. There has been much pushback to Rural Metro, but other decisions have also strenuously insisted that investment bankers avoid any conflicts in merger transactions.

C. Loser Pays: Delaware Reverses Course

1. In ATP Tour Inc. v Deutscher Tennis Bund, 91 A. 3d 554 (Del. 2014), the Delaware Supreme Court upheld the facial validity of a bylaw that shifted the litigation expenses of the corporation and all related parties to a plaintiff that was less than fully successful. Although the case involved a non-stock corporation, the decision drew no distinction between different types of corporations and indicated that a desire to discourage litigation was a reasonable purpose.
2. The decision elicited much controversy, but some 60 or so public corporations quickly adopted similar bylaws in response.
3. The Delaware Bar drafted legislation to overturn the ATP decision (at least as it was applied to stock corporations and not embodied in a stockholder agreement), which passed both Houses of the Delaware Legislative in 2015 (despite intense lobbying against it by the Chamber of Commerce) and becomes effective on August 1, 2015.
4. Idealists say everyone in Delaware realized the decision went too far; cynics say that both sides of the Delaware Bar realized that such bylaws would shut down litigation in Delaware (which is the leading local industry).