Quiet Proxy Season Means Fewer Fights in the Boardroom

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Proxy season is a bust.

Shareholder activism intended to spur change in the boardroom is down significantly so far this year. At the same time, activism by hedge funds to oppose takeover transactions is rising. It appears that hedge funds prefer to battle takeover titans rather than fight for corporate governance issues. If this trend holds, it could change the way corporate America operates.

Proxy season appeared to get a fast start in the fall. Back then, the prominent activist hedge fund Pershing Square Capital Management announced that it had taken sizable positions in J. C. Penney and Fortune Brands.

These announcements heralded another contentious proxy season. It didn't happen.

Instead, as the proxy advisory firm Institutional Shareholder Services noted in a research note last week, only four efforts by hedge funds to replace directors have come to a vote in the first four months of the year. This increased to five on Friday, when Mario Gabelli's Gamco Management lost a proxy contest to place two directors on Myers Industries' board.

According to Factset Sharkrepellent, we typically see about eight such votes by the end of April. The lower numbers reflect a reduction in hedge funds willing to start a proxy contest to replace directors. Last year there were 18 proxy contests through April, but this year there were only 10.

And some of these fights are leading to quick settlements. Of the 10 proxy contests that were to be voted on since the beginning of this year, five have been settled, three went to a vote with the dissident winning in two, and two were withdrawn. The Pershing Square investments never even came to a proxy fight: J. C. Penney and Fortune Brands quickly reached understandings with the hedge fund.

These trends are mirrored in the entire season's figures. According to Factset Sharkrepellent, only 44 proxy fights have been announced as of April 27. At this point in 2009 there were 82 such announcements.

Because companies increasingly require that notice of a proxy contest be given further in advance, it is unlikely that any more proxy contests will be announced this season. There will certainly not be the kinds of battles we have seen in the past years, like those involving Barnes & Noble, CSX and Target.

The only action in proxy season thus far this year appears to be "say on pay." These are recently enacted Securities and Exchange Commission rules requiring a nonbinding shareholder vote on compensation. The law firm Schulte Roth & Zabel reports that in the first 30 days of these rules being in effect, compensation proposals were approved at 93 of 95 companies.

And the corporate governance activist Lucian A. Bebchuk at Harvard Law School and his American Corporate Governance Institute have continued to push for boards to hold annual elections of directors instead of electing directors in one-third tranches each year, making them harder to unseat.

But these are minor currents in what has been a general decline in corporate governance activism.

The takeover activism market is hot, though. Last year, according to Factset Sharkrepellent, 4.6 percent of takeovers faced some type of shareholder activism. In the first four months of this year, the rate has more than doubled to almost 10 percent. This is up from about 3 percent of deals in 2005.

A variety of factors appear to be coming together to explain the decline in shareholder corporate governance activism.

The stock market is in bull territory and valuations are rich, meaning fewer easy targets. Yet the economic outlook remains uncertain, so people are unwilling to take the high risks associated with a proxy contest.

There also appears to be a flow of money out of this sector and into other areas with greater potential for returns. There is not only less money but fewer funds participating in the wake of the financial crisis. Some flame-outs, like Pershing Square's loss on Target, which at one point approached almost $2 billion, have also highlighted the downside to this type of investing.

Companies themselves are also much less willing to engage in proxy contests. These are very costly, and in a financially volatile environment companies do not want to spend the tens of millions of dollars that a proxy contest costs. They are willing to negotiate, meaning settlements and compromise rather than fights.

The surge in merger-and-acquisition activism highlights these factors. Merger arbitrage funds, which speculate on the outcome of takeover transactions, are performing much better and have greater cash inflows than shareholder activist funds. BarclayHedge reports that there was a substantial net inflow of $4.5 billion into arbitrage funds in 2010, with their net assets going to $31.4 billion from $26.9 billion.

The presence of more arbitragers and money creates a self-fulfilling effect. It means more participants to influence a takeover contest.

Unlike shareholder activism, which requires hard work even if you win a proxy contest, merger activism has quick results. This feeds into the primary reason for the surge in takeover activism. Deal agitation has proved to be the most direct and fastest route to activist results over the last few years. It is much cheaper than corporate governance activism.

The decline of activism is partly cyclical. Proxy contests ebb and flow with the economy and market sentiment. We are in a down cycle right now, but if the economy and stock market remain stable, we are likely to enter another up cycle.

There is also a realization that this is really hard work and that the outcomes are less certain. The hedge fund T.C.I., for example, has left this sector since its disastrous foray trying to elect directors at CSX, which resulted in a loss of more than $250 million. In its note, I.S.S. observed a lack of "second growth" activists. This may be a permanent trend and hinder the recovery of corporate governance hedge funds.

There is a vibrant debate over whether corporate governance activism helps or harms corporate America. Those who attack this type of activity claim that it encourages short-termism. Companies will take short-term measures to bolster their share prices in response to activists, and activists themselves are only in it for the short-term lift, not the long-term health of the company.

Others believe that activism serves as an enforcement mechanism, namely that it forces poorly performing management to be more disciplined. The downturn in activism is thus a real loss if it becomes permanent. The reason is not only because of the disciplining effect this activity brings to the target company, but also because of the general fear these activists inspire. No doubt, corporate America is much more focused on its shareholder base and its operations than it was 10 years ago, in part because of these funds.

The downturn in this activity is therefore troubling, but there is an upside: takeovers are about to get more interesting.