Pro-active

Breakingviews
By Richard Beales
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There's an ivory tower barbarian at the gate. Lucian Bebchuk, a Harvard Law School professor, is ratcheting up his battle against corporate defenders like veteran lawyer Martin Lipton. Hedge fund bosses, including Dan Loeb and Bill Ackman, expose real management weaknesses. Even without their resources, though, academic activists like Bebchuk can still be on target.

The spat between Bebchuk and Lipton seems as personal as the one that erupted recently between Ackman, the founder of Pershing Square Capital Management, and billionaire Carl Icahn. Lipton reckons Bebchuk has "aided and abetted" uppity investors in "a form of extortion." Bebchuk, with the aid of two colleagues, fired back in a study that undermines Lipton's credo that activists create only short-term share price pops.

The decades of experience logged by the founding partner of Wachtell, Lipton, Rosen & Katz shouldn't be dismissed, but just as Bebchuk may favor the idea of shareholder democracy, Lipton has long sought to insulate managers from the demands of investors. He sees activism as damaging to a company's long-term prospects even though Bebchuk's research addressed Lipton's concern that previous analyses didn't extend far enough beyond an activist's initial appearance.

In a note to clients on the topic last week, Lipton said he didn't think Bebchuk sufficiently made his case on activists and long-term value. Other academic work has suggested activism may bring little if any benefit or that any share price gains may be limited to cases where companies end up being sold. Even that outcome, though, is still good for shareholders of the acquired companies. And few if any studies seem to support the contention that activists do long-term operational harm.

Modern -day hedge fund interventions can be relatively tame. For instance, Loeb of Third Point recently proposed that Sony spin off its entertainment arm, which he considers undervalued. The company declined, but commitments to transparency – and probably greater focus on the issue behind the boardroom doors – may well ensure Loeb's investment remains in the black for the long term, to the benefit of all shareholders in the Japanese conglomerate.

Activists have also recently tackled instances of strikingly weak governance at companies like Chesapeake Energy and SandRidge Energy. Even Hess, which largely fended off Elliott Management, bowed to some of the hedge fund's demands. In some cases, as Lipton has noted, activists cheekily push for changes already under way. In others, chief executives quietly adopt ideas while publicly rejecting them. Such distinctions needn't matter: sound strategic decisions can bring gains for all shareholders.

Lipton's latest missive subtly shifts the debate by suggesting that activism is but a single facet of a bigger trend toward short-termism in corporate America, one that damages economic growth, competitiveness and employment. That's a broader argument involving – as he recognizes –

legislators, regulators and the entire structure of the investment industry. The general logic can hardly be the thrust of Lipton's advice to clients. Boards of directors need to know what's best for their shareholders, and in this realm Bebchuk's evidence is looking stronger.

Activists don't always play cleanly, of course. For instance, the Children's Investment Fund violated U.S. disclosure rules in its fight with railroad operator CSX five years ago. Moreover, sometimes there are signs of special treatment that doesn't benefit all shareholders. Third Point's partial exit from its investment in Yahoo last month looks a case in point.

Lipton also has reasonably criticized activists who pay their sponsored directors large bonuses for achieving quick stock price gains. These special arrangements align one boardroom faction with the short-term interest of a specific shareholder.

If that kind of distortion can be avoided, however, hedge funds willing to go to the trouble and expense of taking company bosses to task help solve the agency problem so common in public companies. Because ownership is often both fragmented and intermediated by money managers, most shareholders can't or don't have enough incentive to act like owners.

That in turn permits boards and managers to become complacent. Any CEO worth his generous compensation package should, along with his board, be willing to listen to a big shareholder's ideas for improvement. Sheltering managers and directors, as Lipton advocates, makes that less likely. He has a point about the bigger questions. When it comes to activism, though, Bebchuk has Lipton on the back foot.