Empirical Work on the Long-Term Effects of Activist Interventions

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The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Current Thoughts About Activism

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Friday August 9, 2013

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, and Sabastian V. Niles. Work from the Program on Corporate Governance about hedge fund activism includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon P. Brav, and Wei Jiang.

A long-term oriented, well-functioning and responsible private sector is the country's core engine for economic growth, national competitiveness, real innovation and sustained employment. Prudent reinvestment of corporate profits into research and development, capital projects and value-creating initiatives furthers these goals. Yet U.S. companies, including well-run, high-performing companies, increasingly face:

- pressure to deliver short-term results at the expense of long-term value, whether through excessive risk-taking, avoiding investments that require long-term horizons or taking on substantial leverage to fund special payouts to shareholders;
- challenges in trying to balance competing interests due to excessively empowered special interest and activist shareholders; and
- significant strain from the misallocation of corporate resources and energy into mandated activist or governance initiatives that provide no meaningful benefit to investors or other critical stakeholders.

These challenges are exacerbated by the ease with which activist hedge funds can, with-out consequence, advance their own goals and agendas by exploiting the current regulatory and institutional environment and credibly threatening to disrupt corporate functioning if their demands are not met. Activist hedge funds typically focus on immediate steps, such as a leveraged recapitalization, a split-up of the company or sales or spinoffs of assets or businesses that may create an increase in the company's near term stock price, allowing the activist to sell out at a profit, but leave the company to cope with the increased risk and decreased flexibility that these steps may produce.

The power of the activist hedge funds is enhanced by their frequent success in proxy fights and election contests when companies resist the short-term steps the hedge fund is advocating. These proxy contest successes, in turn, are enabled by the outsized power of proxy advisory firms and governance reforms that weaken the ability of corporate boards to resist short-term pressures. The proxy advisory firms are essentially unregulated and often demonstrate a bias in favor of activist shareholders. They also tend to take a one-size-fits-all approach to policy and voting recommendations without regard for or consideration of a company's unique circumstances. This approach includes the potential for across-the-board "withhold votes" from directors if the directors fail to implement any shareholder proposal receiving a majority vote, even if directors believe that the proposal would be inconsistent with their fiduciary duties and the best interests of the company and its shareholders. Further complicating the situation is the fact that an increasing number of institutional investors now invest money with the activist hedge funds or have portfolio managers whose own compensation is based on short-term metrics, and increasingly align themselves with the proposals advanced by hedge fund activists. In this environment, companies can face significant difficulty in effectively managing for the long-term, considering the interests of employees and other constituencies, and recruiting top director and executive talent.

Although there is no single solution to these problems, the following perspectives and actions may help to restore a more reasonable balance:

- Recognize that the proper goal of good governance is creating sustainable value for the benefit of all stakeholders, rather than reflexively placing more power in the hands of activist hedge funds or often-transient institutional shareholders who are themselves measured by short-term, quarterly portfolio performance;
- Resist the push to enact legislation, regulations or agency staff interpretations that place more power in the hands of activist hedge funds and other investors with short-term perspectives, and that thereby weaken the ability of corporate boards to resist such short-term pressures; and
- In any new legislation or regulation that is enacted, provide appropriate protections to companies, as opposed to focusing only on new rights for shareholders who already have significant leverage to pressure companies.

Some specific examples of possible steps to implement these general principles may include the following:

- SEC Commissioner Daniel Gallagher recently questioned whether "investment advisors are indeed truly fulfilling their fiduciary duties when they rely on and follow

recommendations from proxy advisory firms" and expressed "grave concerns" about institutional investors engaging in "rote reliance" on proxy advisory firms' advice. He attributed this in part to the unintended consequences of two SEC staff no-action letters from 2004, which he noted were not approved by the Commission and did not necessarily represent the views of the Commission or the Commissioners, that had "unduly increased the role of proxy advisory firms in corporate governance" by "essentially mandating the use of third party opinions." *New Commission-level guidance could replace these staff interpretations and, instead, encourage proxy voting based on individual evaluation of each company and its long-term best interests. Other agencies may also wish to keep in mind this illustration of unintended and undesired outcomes as appropriate.*

- Activist shareholders take advantage of Securities Exchange Act Rule 14a-8 to force the inclusion, year-after-year and notwithstanding prior failures, of corporate governance and business-related shareholder proposals in public company proxy statements that have little connection to effective governance or the creation of long term shareholder value. These proposals can be misused to exert leverage over companies, and dealing with the deluge distracts from the business and requires significant time and resources. *Rule 14a-8 should be revisited to raise the bar on inclusion of shareholder proposals. This could include more substantial and longer-term ownership requirements to be eligible under Rule 14a-8, and exclusion of proposals in subsequent years that did not obtain a truly meaningful level of support (current rules prohibit a company from excluding a repeat proposal the following year unless 97% of the shares reject it the first time or 90% of the shares reject it at least three times, standards that are far too low)*.
- Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co., have disproportionate influence over voting decisions made by every public company's institutional shareholder base and regularly support activist shareholders and hedge funds. Their recommendations and analyses may also contain material inaccuracies, and companies have little visibility into the preparation of these reports and the proxy advisory firms' methodologies. *We believe that the proxy advisory firms should be held to reasonable standards to ensure transparency, accuracy and the absence of conflicts and that the special regulatory treatment given to these firms should end.*
- Activist hedge funds have recently exploited loopholes in existing SEC rules under Section 13(d) of the Securities Exchange Act to accumulate significant, control-influencing stakes in public companies rapidly without timely notice to the market. These techniques are facilitated by the widespread use of derivatives, advanced electronic trading technology and increased trading volumes. Many non-U.S. securities markets have already taken action to address the risks of such rapid, undisclosed accumulations.

A rulemaking petition, pending before the SEC since March 2011, would close the derivatives loophole and require acquirers of 5% stakes to disclose such positions to the public within one day, instead of the current ten-day window established forty years ago. *We believe approval of this rulemaking petition will help curb abuses and bring the rules current with con-temporary practices and technologies.*

- Companies face significant difficulty engaging with their institutional shareholder base because the current reporting regime does not provide timely information to companies as to who their shareholders are. A second rulemaking petition pending before the SEC, submitted in February 2013, requests that the SEC shorten the deadline for institutional investors to report their positions on Forms 13F from 45 days to two business days after quarter-end and increase the frequency with which shareholders report their position. The petition also supports reform of the Section 13(d) stock accumulation rules. *We believe approval of this rulemaking petition will promote market transparency and facilitate engagement between companies and shareholders.*
- Harvard Law School Professor Lucian Bebchuk has established the Harvard Law School Shareholder Rights Project (previously discussed here) to promote corporate governance that facilitates activist hedge fund attacks on companies. He has also published several articles and editorials arguing that activist attacks are beneficial to the targeted companies and should be encouraged. His articles and editorials are widely used by activist hedge funds and institutional share-holders to justify their actions. *We believe that the statistics Professor Bebchuk uses do not establish the validity of his claims that activist attacks are beneficial nor justify his uncritical embrace of activists. We believe that attacks, and the threat of attacks, by activist hedge funds and pervasive activism have significant implications for the broader economy and our nation's competitiveness and are major contributors to unemployment and slow growth of GDP. We believe that the recent studies by:*
    - Professor Pavlos E. Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies*
    - Professor Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*
    - Professor Colin Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it*
    - Professor David Larcker and Brian Tavan, *A Real Look at Real World Corporate Governance*

reflect the true effects of activism and that it is in the national interest to reverse the legislation and regulation that promotes activism.

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The Bebchuk Syllogism

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Monday August 26, 2013

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, Eric S. Robinson, Karessa L. Cain, and Sabastian V. Niles. This post focuses on a recent study by Lucian Bebchuk, Alon Brav, and Wei Jiang, The Long-Term Effects of Hedge Fund Activism, available here, and discussed in a post by the authors here. An earlier post by Martin Lipton including a criticism of this study is available here. A related article by Lucian Bebchuk, The Myth that Insulating Boards Serves Long-Term Value, is discussed on the Forum here.

> *Empirical studies show that attacks on companies by activist hedge funds benefit, and do not have an adverse effect on, the targets over the five-year period following the attack.*
>
> *Only anecdotal evidence and claimed real-world experience show that attacks on companies by activist hedge funds have an adverse effect on the targets and other companies that adjust management strategy to avoid attacks.*
>
> *Empirical studies are better than anecdotal evidence and real-world experience.*
>
> *Therefore, attacks by activist hedge funds should not be restrained but should be encouraged.*

Harvard Law School Professor Lucian A. Bebchuk is now touting this syllogism and his obsession with shareholder-centric corporate governance in an article entitled, "The Long-Term Effects of Hedge Fund Activism" (previously discussed here). In evaluating Professor Bebchuk's article, it should be noted that:

There is heavy reliance in the article on Tobin's Q (*i.e.*, a ratio of market value to book value, with book value intended to serve as a proxy for replacement value) to measure the performance of the targets of activist attacks, and the article presents the data in a way that makes the statistical

analysis appear favorable to Professor Bebchuk's argument. The article highlights the average Q ratio for companies subject to activist attack in the following five years. Since averages can be skewed by extreme results (as the article acknowledges), focusing on the median outcome would be more appropriate. Indeed, the article presents median results, but does not reference in the text that the median Q ratio for each of the first four years following the attack year is lower than the median Q ratio in the year of the activist attack. Only in year five does the median Q ratio exceed the Q ratio in the attack year. While the article fails to disclose the average holding period of the activists in the study, it is undoubtedly less than five years. So it seems quite speculative, at best, to credit activists with improvements in Q ratios that first occur for the median company only in the fifth year after the attack.

Beyond the highly questionable conclusions Professor Bebchuk draws from his Tobin's Q statistics, there is also the fundamental question of whether Tobin's Q is a valid measure of a company's performance. A 2012 paper by Olin School of Business Professor Philip H. Dybvig, "Tobin's q Does Not Measure Firm Performance: Theory, Empirics, and Alternative Measures," points out that Tobin's Q is inflated by underinvestment, so a high Q is not evidence of better company performance. Companies that forego profitable investment opportunities—including as a result of pressure from activists to return capital to investors or defer investments in R&D and CapEx—can actually have higher Q ratios while reducing shareholder value that would have been generated by those investments. In addition, the use of book value as a proxy for replacement value introduces complications from different accounting decisions, including the timing of write-downs, depreciation methods, valuation of intangibles and similar decisions that can significantly distort a company's Q ratio. The other metric that Professor Bebchuk relies on in his article—return on assets (ROA)—is highly correlated with Tobin's Q (indeed, both ratios use the same denominator, and the numerators are substantially related), and thus his ROA statistics suffer from these same shortcomings and add little to the analysis.

Further undermining the validity of the empirical analysis, the article acknowledges but fails to control for the fact that 47% of the activist targets in the dataset cease to survive as independent companies throughout the measurement period. The study sheds no light on whether the shareholders of those companies would have realized greater value from other strategic alternatives that had a longer-term investment horizon, whether those companies were pressured to sell on account of the activist attack (as other empirical work has argued), or whether shareholder gains from activism are largely driven by the cases that result in sales of control.

Lastly, Professor Bebchuk concedes that his analytical methodology provides no evidence of causation, and thus simply misses the crux of the debate: whether activists can impair long-term value creation. Favorable results would arise under his approach whenever managements of the

target companies pursue value-enhancing strategies, even those that run counter to the activists' pressures or were being initiated even before the activist appeared. In addition, improving economic, market, industry and company-specific conditions would also contribute to favorable results independent of activist pressure. Professor Bebchuk also states that the targets in his dataset "tend to be companies whose operating performance was below industry peers or their own historical levels at the time of [activist] intervention"; if true, it is plausible that many companies improved from a historical or cyclical trough position in spite of—rather than as a result of—activist pressures.

These defects, among others, are sufficient in and of themselves to raise serious doubts about the conclusions that Professor Bebchuk draws from his empiricism. But there is a more fundamental flaw in Professor Bebchuk's syllogism: it rejects and denies the evidence, including anecdotal evidence and depth of real-world experience, that he acknowledges in the article comes from a "wide range of prominent writers… significant legal academics, noted economists and business school professors, prominent business columnists, important business organizations, and top corporate lawyers."

No empirical study, with imperfect proxies for value creation and flawed attempts to isolate the effects of activism over a long-term horizon influenced by varying economic, market and firm-specific conditions, is capable of measuring the damage done to American companies and the American economy by the short-term focus that dominates both investment strategy and business-management strategy today. There is no way to study the parallel universe that would exist, and the value that could be created for shareholders and other constituents, if these pressures and constraints were lifted and companies and their boards and managements were free to invest for the long term. The individuals who are directly responsible for the stewardship and management of our major public companies—while committed to serious engagement with their responsible, long-term shareholders—are nearly uniform in their desire to get out from under the short-term constraints imposed by hedge-fund activists and agree, as do many of their long-term shareholders, that doing so would improve the long-term performance of their companies and, ultimately, the country's economy.

Reflecting on Professor Bebchuk's article and failed syllogism, one is reminded of Mark Twain's saying, "There are three kinds of lies: lies, damned lies and statistics."

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Don't Run Away from the Evidence: A Reply to Wachtell Lipton

Posted by Lucian Bebchuk, Harvard Law School, Alon Brav, Duke University, and Wei Jiang, Columbia Business School, on Tuesday September 17, 2013

Editor's Note: Lucian Bebchuk is Professor of Law, Economics, and Finance at Harvard Law School. Alon Brav is Professor of Finance at Duke University. Wei Jiang is Professor of Economics and Finance at Columbia Business School. This post responds to two Wachtell Lipton memoranda posted by Martin Lipton, available on the Forum here and here. These memoranda criticize the recently-issued empirical study by Bebchuk, Brav, and Jiang on the long-term effects of hedge fund activism. The study is available here, and its results are summarized in a Forum post and in a Wall Street Journal op-ed article.

In two recent memoranda by the law firm of Wachtell Lipton (Wachtell), The Bebchuk Syllogism (Syllogism memo) and Current Thoughts about Activism (Current Thoughts memo), the firm's founder Martin Lipton and several other senior Wachtell lawyers strongly criticize our recent study, The Long-Term Effects of Hedge Fund Activism. Our study empirically disproves the myopic activists claim that interventions by activist hedge funds are in the long term detrimental to the involved companies and their long-term shareholders. This post responds to the main criticisms of our work in Wachtell's memos. Below we proceed as follows:

- First, we discuss the background of how our study meets a challenge that Wachtell issued several months ago;
- Second, we highlight how Wachtell's critiques of our study fail to raise any questions concerning the validity of our findings concerning long-term returns, which by themselves are sufficient to undermine the myopic activists claim that Wachtell has long been putting forward;
- Third, we explain that the methodological criticisms Wachtell directs at our findings concerning long-term operating performance are unwarranted;
- Fourth, we show that Wachtell's causality claim cannot provide it with a substitute basis for its opposition to hedge fund activism;
- Finally, we explain why Wachtell's expressed preference for favoring anecdotal evidence and reports of experience over empirical evidence should be rejected.

The Wachtell Challenge

According to opponents of hedge fund activism, activist interventions may pump up short-term stock prices and benefit the activists—who don't stick around to eat their own cooking—but tend to harms shareholders in the long term. As is described in detail in The Myth that Insulating Boards Serves Long-Term Value (Part I) (the Myth study), this myopic activists claim has long been an influential key argument in debates over hedge fund activism and corporate governance more generally, and Wachtell and its founder Martin Lipton have been making this claim frequently and forcefully—though with little empirical evidence to support it.

Wachtell has been a highly successful advisor to boards seeking to "defend vigorously" against interventions by activist hedge funds (see Wachtell's well-known memo Dealing With Activist Hedge Funds for a brief outline of its approach). Going beyond the provision of such expert advice, however, Wachtell has also been attempting to put forward a policy basis for the opposition to hedge fund activism and to persuade policymakers to adopt or allow measures curbing such activism.

Last November, Martin Lipton and one of us (Bebchuk) held a debate sponsored by the Conference Board on one of the policy measures that Wachtell is seeking in order to discourage activism. During this debate, Bebchuk noted that he was engaged in a co-authored empirical study of the myopic activists claim. Following the debate, in his Bite the Apple memo, Martin Lipton issued a challenge for the research project that we were carrying out. In particular, he argued that "if Professor Bebchuk is truly interested in meaningful research to determine the impact of an activist attack," our research study should examine the following:

> "[F]or companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period."

Our study indeed met this challenge. Analyzing the full universe of approximately 2,000 interventions by activist hedge funds during the period 1994–2007, the study tracks changes in the company's operating performance and stock return performance during the five-year period after the "intervention month" in which the activist initiative was first publicly disclosed.

Our study disproves empirically the myopic activists claim that Wachtell has been putting forward for many years with no empirical evidence to support it. We find that the asserted long-term declines in shareholder wealth and operating performance are not supported by the data. The results of our study are summarized in a post on the Forum here and in a WSJ op-ed article here.

If Wachtell were “truly interested in meaningful research to determine the impact of an activist attack,” it could have been expected to welcome the arrival of a study that provides a systematic analysis of the very question it posed as important and to build upon it. Not so. In its two recent memos, Wachtell urges disregarding the evidence in our study as well as any future empirical work on the subject.

Importantly, Wachtell does not argue that we failed to conduct our study in the best possible way currently available or recommend that we or others conduct a different empirical analysis of the question posed in the Bite the Apple memo. Rather, faced with empirical findings that do not support its myopic activists claim, Wachtell seeks to avoid reliance on our or any subsequent empirical work on the subject and to base policymaking instead on the insights obtained from “anecdotal evidence and deep real-world experience.”

As explained below, Wachtell’s memos raise some unwarranted criticisms as well as some relevant points that we ourselves discuss in our study. None of the points raised, however, provides a basis for Wachtell’s appeals for disregarding our empirical evidence and for relying on anecdotes and reported experiences.

Stock Returns Results

To begin, we should highlights that Wachtell limits its methodological criticism concerning the validity of our findings solely to our results about operating performance. Importantly for the ongoing policy debate, Wachtell does not challenge our finding that negative long-term returns, asserted by the myopic activists claim, are not found in the data.

Stock prices increases commonly accompany disclosure filings indicating the arrival of hedge-fund activists. However, Wachtell and other opponents of activism have viewed these stock price spikes as merely reflecting inefficient market pricing in the short term. For this reason, Wachtell’s Bite the Apple memo challenged our research project to analyze returns post the 24-month period to examine the possibility that reversals of fortune and negative stock returns take place then.

Using three alternative methodologies for identifying negative abnormal stock returns used by financial economists, our study finds—and Wachtell does not question this key finding—that the asserted long-term reversal of the initial stock price is not found in the data. Contrary to Wachtell’s belief that the market fails to appreciate the long-term consequences of activism, long-term shareholders in fact do not suffer any negative abnormal returns during the five-year period following interventions. We hope that, going forward, Wachtell and other corporate advisors will revise the advice they offer boards accordingly.

Operating Performance Results

Our study finds that operating performance relative to industry peers, measured using Tobin's Q and return on assets (ROA), improves through the end of five-year period following interventions. Wachtell raises two methodological criticisms concerning the validity of these findings.

First, Wachtell makes an unwarranted criticism based on the difference between means and medians. It argues that "averages can be skewed by extreme results" and criticizes our discussion of an initial table (Table 2) for not stressing the difference in results (displayed in that Table) obtained using means and medians. However, that initial table is altogether of little significance for our analysis: Table 2 presents summary statistics of "raw" levels—levels that are not adjusted relative to industry peers—and, as we explain in our study, the standard approach by financial economists is to control by industry. In our subsequent Table 3, which presents summary statistics using industry-adjusted levels, the results are in fact similar using both means and medians: in both cases, industry-adjusted operating performance, measured by either Tobin's Q or ROA, is higher in each of the five years following the intervention year than during the intervention year. Furthermore, our key findings regarding operating performance are based on a regression analysis, not the summary statistics of Tables 2 and 3, and that analysis uses standard methods for avoiding excessive influence of outlier observations.

Second, Wachtell argues that Tobin's Q and ROA are imperfect metrics for measuring operating performance. While no metric of operating performance is viewed by financial economists as perfect, we chose these two methods, as we explain in our study, because their use as operating performance metrics is standard among financial economists working on corporate governance issues. Tobin's Q, in particular, has been used as a key metric for operating performance by numerous studies in peer-reviewed journals, including such influential and widely cited studies as Morck, Shleifer and Vishny, (1988), McConnell and Servaes (1990), Lang and Stulz (1994), Yermack (1996), Daines, (2001), and Gompers, Ishii and Metrick (2003).

In questioning the use of Tobin's Q and ROA, Wachtell relies on an unpublished paper by Philip Dybvig and Mitch Warachka. These authors discuss potential imperfections in the use of Tobin's Q and suggest two alternative metrics of operating performance that, to the best of our knowledge, have not yet been used by any other empirical study that has been published or made available on SSRN since the Dybvig-Warachka paper was first placed on SSRN in 2010. We can only imagine how strongly Wachtell would have criticized us if we chose to base our study on some non-standard metrics of operating performance. Indeed, Wachtell does not argue that we failed to make the best possible choices in a world with imperfect metrics for operating

performance. As we will discuss below, Wachtell's thesis is that any empirical evidence is bound to be so imperfect that it best be disregarded.

The Stock Picking Claim

Wachtell also stresses a point that we discuss in detail in our study—that the identified association between activist intervention and subsequent improvements in operating performance does not by itself demonstrate a causal link. Such association could in theory reflect activists' ability to choose targets whose operating performance is expected to increase in any event. Under such a scenario, the improvement in long-term performance experienced by targets reflect the activist's "stock picking" ability rather than the activist's impact on the company's operating performance.

Wachtell's making this claim already represents a substantial shift in position. Accepting that activist interventions are followed by improvements in operating performance, and merely questioning whether activists should "get credit" for these improvement, is very different from the myopic activists claim that Wachtell has been making for many years—asserting long-term declines in operating performance to advocate measures that impede activist interventions. To the extent that these interventions are actually followed by improvements in operating performance, the post-intervention changes in operating performance do not provide a basis for measures to curb such interventions.

Furthermore, as we explain in our study (section III.D.2), there are reasons to believe that the identified improvements in operating performance are at least partly due to the activist interventions:

- First, the evidence suggests that the activists themselves are willing to expend significant resources because they believe that their activities contribute to the subsequent improvements in operating performance. Activism involves significant costs. If hedge fund activists believed that the improvements in performance would ensue even without their bearing such costs, they would just buy a stake and, without bearing any of the costs of activism, passively capture the benefits of the improved performance expected to take place.
- Second, our study shows that operating performance improvements follow also the subset of activist interventions that employ adversarial tactics, which are used when companies are expected to resist the activists' suggested course of action. This finding is in tension with the view that the improvements in operating performance following activist

interventions are due to corporate actions that incumbents would take even without any activist intervention.

- Third, earlier work co-authored by two of us shows that improvements in operating performance do not systematically take place after outside blockholders pursuing a passive strategy announce the purchase of a block of shares—but do occur after a subset of the blockholders switch from passive to activist stance. This finding is also consistent with the view that the association between interventions and subsequent improvement in operating performance are at least partly a product of the activists' work and not merely a reflection of their foresight in choosing targets.

The Rejection of Empirical Evidence

In raising questions concerning our finding, the Wachtell critiques are not aiming at identifying issues that should be addressed differently in subsequent empirical work. While the Bite the Apple memo put forward questions and challenged empirical work to answer them, Wachtell, not happy with the answers that our empirical work provided to these questions, is now giving up on empirical work, arguing that "no empirical work" is capable of measuring the long-term effects of hedge fund activism. Instead, Wachtell believes that it would be better to follow the insights coming from "anecdotal evidence and depth of real-world experience."

By real-world experience, Wachtell refers to the experience of company managers and directors, as well as their advisors. In the Bite the Apple memo, Lipton urged reliance on "the decades of my and my firm's experience in advising corporations" as evidence of the detrimental effects of hedge fund activism. Lipton surely can be expected to oppose policymakers relying on assertions by leaders of activist hedge funds that their own real-world experience provides reliable evidence that their interventions are beneficial in the long term.

When available, economists commonly prefer objective empirical evidence over unverifiable reports of affected individuals. Sometimes, in the absence of empirical evidence, substantial reliance on such reports is unavoidable. In the present context, however, public information about stock returns and financial performance can and should be used to assess the myopic activists claim.

The use of such data provides objective evidence that is valuable for policymaking. The Bite the Apple memo was right in encouraging empirical testing of the operating performance and stock return performance post the 24-month period following activist interventions. By contrast, the recent Wachtell critiques are wrong in seeking to discourage the use of such empirical work.

We would welcome it if Wachtell (or some other resource-rich business organizations that share its views) were to contribute to the policy debate by conducting or commissioning an empirical study that would improve upon ours in some methodological or other way. In the meantime, however, Wachtell should not disregard the existing empirical evidence and should not dismiss the value of any empirical work on the subject. In our opinion, Wachtell should engage with the evidence, not try to run away from it.

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Empiricism and Experience; Activism and Short-Termism; the Real World of Business

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Monday October 28, 2013

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton that replies to a post published by Professor Lucian Bebchuk, available here, which in turn responds to two Wachtell Lipton memoranda posted by Martin Lipton, available on the Forum here and here. These memoranda criticize the recently-issued empirical study by Bebchuk, Brav, and Jiang on the long-term effects of hedge fund activism. The study is available here, and its results are summarized in a Forum post and in a Wall Street Journal op-ed article.

Harvard Law School Professor Lucian Bebchuk believes that shareholders should be able to control the material decisions of the companies they invest in. Over the years, he has written numerous articles expressing this view, including a 2005 article urging that shareholders should have the power to initiate a shareholder referendum on material corporate business decisions. In addition to his writings and speeches, Prof. Bebchuk has established and directs the Shareholder Rights Project at Harvard Law School for the purpose of managing efforts to dismantle classified boards and do away with other charter or bylaw provisions that restrain or moderate shareholder control of corporations (see "Harvard's Shareholder Rights Project is Wrong" and "Harvard's Shareholder Rights Project is Still Wrong"). In addition, Prof. Bebchuk has been at the forefront in arguing to the SEC that, despite the specific action of Congress in 2010 to empower the SEC to adopt a rule to require fair and prompt public disclosure of accumulations of shares by activist hedge funds and other blockholders, the SEC should not do so because it would limit the ability of activist hedge funds to attack corporations. In short, Prof. Bebchuk believes that shareholders should have the power to control the fundamental decisions of corporations—even those shareholders who bought their shares only a few days or weeks before they sought to assert their power, and regardless of whether their investment objective is short-term trading gains instead of long-term value creation.

While there is no question that almost every attack, or even rumor of an attack, by an activist hedge fund will result in an immediate increase in the stock market price of the target, such gains

are not necessarily indicative of real value creation. To the contrary, the attacks and the efforts by companies to adopt short-term strategies to avoid becoming a target have had very serious adverse effects on the companies, their long-term shareholders, and the American economy. To avoid becoming a target, companies seek to maximize current earnings at the expense of sound balance sheets, capital investment, research and development and job growth. Indicative of the impact of shareholder pressure for short-term performance is the often cited comment by then-Citigroup CEO Chuck Prince in the July 9, 2007 *Financial Times*: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." Many commentators have cited pressure to boost short-term performance metrics as one of the causes of the 2008 fiscal crisis, such as Lynne Dallas in her 2012 article in the *Journal of Corporation Law* ("[t]he financial crisis of 2007-2009 was preceded by a period of financial firms seeking short-term profit regardless of long-term consequences") and Sheila Bair in her last speech as FDIC chairman in 2011 ("the overarching lesson of the crisis is the pervasive short-term thinking that helped to bring it about"). Virtually all of the academic and government studies of the fiscal crisis have concluded that shareholder pressure was a contributing cause.

In August of this year, Prof. Bebchuk released an article describing what he characterized as empirical evidence that attacks by activist hedge funds do not harm companies and their long-term shareholders (see "The Long-Term Effects of Hedge Fund Activism"). I released a paper pointing out serious deficiencies in the methodology, analysis and conclusions that Prof. Bebchuk used and I cited an academic study questioning his statistics, an empirical study to the contrary and real-world experience and anecdotal evidence that activism and its concomitant short-termism destroy long-term value and damage the American economy (see "The Bebchuk Syllogism"; see also "Current Thoughts About Activism" and "Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy"). Apparently, my paper touched a raw nerve. In an attempt to resuscitate his promotion and justification of attacks by activist hedge funds, Prof. Bebchuk has published a new paper ("Don't Run Away from the Evidence: A Reply to Wachtell Lipton") accusing me of running away from the evidence; a serious accusation, but demonstrably untrue. Let's take a look at some of the evidence (empirical, experiential, and overwhelming) that supports my views.

Empirical Evidence

It should be noted that Prof. Bebchuk's claim that "supporters of the myopic activists view have failed to back their view with empirical evidence or even to test empirically the validity of their view" is patently false. In fact, numerous empirical studies over the years have produced results that conflict with those Prof. Bebchuk espouses. These other studies generally find that activism has a negative effect or no effect on long-term value, particularly when controlling for the skewing

impact of a takeover of the target (which generally occurs at a premium regardless of whether the target is the subject of activism). This fact compels a careful assessment and critical review of his study to determine why his results differ from many prior studies—something I attempted to provide in my previous paper. I have provided below a brief, and admittedly incomplete, sampling of such studies.

Director Contests and Firm Performance

- According to Jonathan Macey and Elaine Buckberg in their 2009 "Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation," there are "[s]everal studies [that] establish that when dissident directors win board seats, those firms underperform peers by 19% to 40% over the two years following the proxy contest."
- One of those studies is David Ikenberry and Josef Lakonishok's "Corporate Governance Through the Proxy Contest" (published in the *Journal of Business* in 1993), which reviewed 97 director election contests during a 20-year period in order to examine the long-term performance of targeted firms subsequent to a proxy contest. Their findings were striking: "When the incumbent board members successfully retain all board seats, cumulative abnormal returns are not significantly different from zero over the next 5 years. Yet, in proxy contests where dissidents obtain one or more seats, abnormal returns following resolution of the contest are significantly negative. Two years following the contest, the cumulative abnormal return has declined by more than 20%. The operating performance of these same firms during the postcontest period is also generally consistent with the pattern observed using stock returns."
- Michael Fleming obtained similar results when looking at instances where a dissident obtains board representation in "New Evidence on the Effectiveness of the Proxy Mechanism," a 1995 Federal Reserve Bank of New York research paper. Reviewing a sample of 106 threatened proxy contests between 1977 and 1988, Fleming found statistically significant negative returns of -19.4% in the 24 months following the announcement of a contested election for the 65 firms in his sample where dissidents won board seats—either as a result of a shareholder vote or a settlement. Fleming found that the majority of gains resulting from threatened proxy contests were "attributable to firms which [we]re acquired within one year of the outcome of the proxy contest," suggesting that the gains were due to payment of a takeover premium (consistent with Greenwood and Schor's findings described below), *not* from operating improvements or governance changes.
- Lisa Borstadt and Thomas Zwirlein found very similar results in "The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance," published in *Financial Management* in 1992. These authors examined 142

exchange-traded firms involved in proxy contests for board representation over a 24-year period. They found the following: “A dissident victory in the proxy contest does not necessarily translate into superior corporate performance. Positive abnormal returns over the proxy contest period are realized by firms in which the dissidents win the proxy contest and the firm is subsequently taken over. In contrast, no abnormal performance over the contest period is observed for the firms in which the dissidents win but the firm is not subsequently taken over. For these firms, large negative (although insignificant) cumulative returns are observed in the postcontest period.”

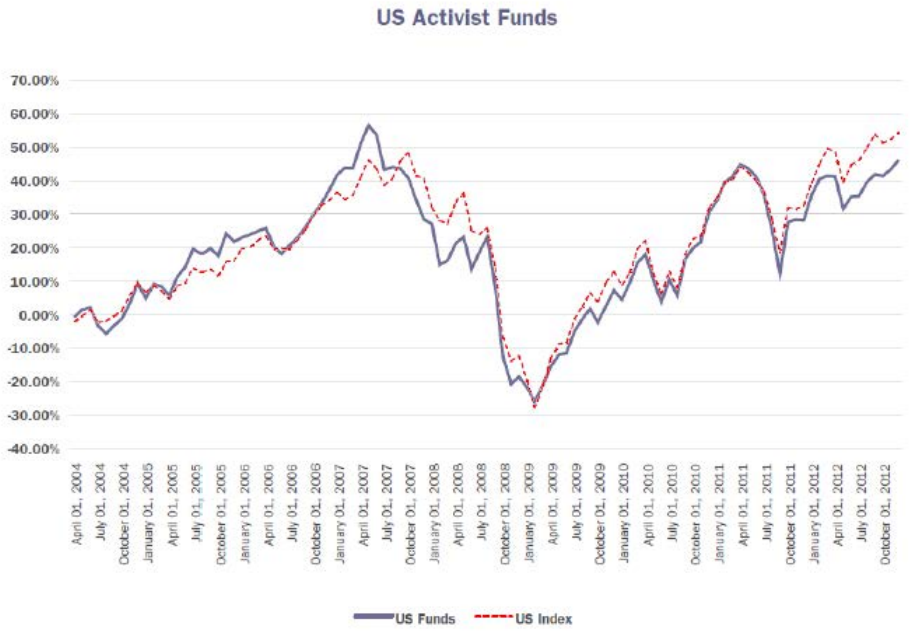
Shareholder Proposals and Firm Performance

- In “Investor Activism and Takeovers,” published in the *Journal of Financial Economics* in 2009, Robin M. Greenwood and Michael Schor examined Schedule 13D filings by portfolio investors between 1993 and 2006 to investigate the effect of activist interventions on stock returns. They found the following: “[A]ctivism targets earn high returns primarily when they are eventually taken over. However, the majority of activism targets are not acquired and these firms earn average abnormal returns that are not statistically distinguishable from zero. … Thus, the returns associated with activism are largely explained by the ability of activists to force target firms into a takeover, thereby collecting a takeover premium.”
- In “Pension Fund Activism and Firm Performance,” published in the *Journal of Financial and Quantitative Analysis* in 1996, Sunil Wahal reviewed 356 “targetings” by the nine most active funds between 1987 and 1993. “Targetings” included both proxy proposals and nonproxy targeting, and were typically initiated by sending a letter to the target firm (either publicly or privately) followed by a telephone call from the activist fund. Wahal found that, while pension funds “are reasonably successful in changing the governance structure of targeted firms,” these changes have no impact on stock performance. According to Wahal, “targeting announcement abnormal returns are not reliably different from zero,” and “[t]he long-term abnormal stock price performance of targeted firms is negative prior to targeting and still is negative after targeting.” Wahal also found that “accounting measures of performance do not suggest improvements in operating or net income either; accounting measures of performance also are negative prior to and after targeting.”
- Two studies released by the U.S. Chamber of Commerce in partnership with Navigant Consulting reviewed shareholder proxy proposals between 2002-2008 and 2009-2012, respectively, for impact on firm performance. The studies, published in May 2009 and May 2013, both focused on shareholder proposals that were identified as “Key Votes” by the AFL-CIO in annual surveys during the respective time periods, including proposals

reflecting board declassifications, proxy access and director removal policies. In the first study, "Analysis of the Wealth Effects of Shareholder Proposals—Volume II," João Dos Santos and Chen Song reviewed 166 shareholder proposals between 2002-2008 and found "no evidence of a statistically significant overall short-run or long-run improvement and some indication of a long-run decrease in market value for the firms in our sample." In the second study, "Analysis of the Wealth Effects of Shareholder Proposals—Volume III," which reviewed 97 shareholder proposals between 2009-2012, Allan T. Ingraham and Anna Koyfman came to similar conclusions: "We … find no conclusive or pervasive evidence that the shareholder proposals assessed in this study improve firm value or result in an economic benefit to pension plans and plan participants. Given that the proxy process imposes costs on both firms and shareholders, and given that there are no proven benefits in terms of corporate performance, the overall net benefit of these initiatives is likely negative."

- Andrew K. Prevost and Ramesh P. Rao studied the impact of shareholder activism by public pension funds in their paper "Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?" (published in the *Journal of Business* in 2000), examining a total of 73 firms that received shareholder proposals during the period of 1988-1994. They came to the following conclusions: "Firms that are subject to shareholder proposals only once during the sample period experience transitory declines in returns, but firms that are subject to repeat shareholder proposals experience permanent declines in market returns. … Long-term changes in operating performance corroborate the event study results: firms targeted only once exhibit positive but insignificant long- term results, while those targeted repeatedly show strong declining performance."
- Jonathan M. Karpoff, Paul H. Malatesta and Ralph A. Walkling reviewed 522 shareholder proposals at 269 companies between 1986 and 1990 to determine the impact of shareholder proposals on firm performance in "Corporate Governance and Shareholder Initiatives: Empirical Evidence," published in the *Journal of Financial Economics* in 1996. After finding that "proposals are targeted at poorly performing firms," they concluded that, notwithstanding this fact, the "average effect of shareholder corporate governance proposals on stock values is close to, and not significantly different from, zero." In fact, "[s]ales growth declines for firms that receive proposals in relation to sales growth for control firms," "[c]hanges in operating return on sales are not significantly larger for proposal firms than their controls, and are not significantly related to the persistence or intensity of proposal pressure, or to the sponsors' identity," and "[c]hange in operating ROA are not related to the pressure's intensity or sponsors' identity."

- In “Less is More: Making Institutional Shareholder Activism a Valuable Mechanism of Corporate Governance,” published in the *Yale Journal on Regulation* in 2001, Yale Law School professor Roberta Romano conducted a review of the corporate finance literature on institutional investors’ corporate governance activities, involving seven different empirical studies and a total of over 4,500 individual shareholder proposals. She found that the shareholder proposals had “little or no effect on targeted firms’ performance” over the time periods considered in the studies and proposed that improvements might be achieved if the rules were revised “to require proposal sponsors either to incur the full cost of a losing proposal or a substantial part of the cost.”
- It is particularly noteworthy that CalSTRS, one of the major public employee pension funds and one of the leaders in proxy voting and investing in activist hedge funds, has recently reported that its aggregate investments in activist funds as of October 2012 trailed the United States public equity market, as shown by this chart from its annual report.



Click here to enlarge

If activist funds fail to achieve attractive returns for their own investors, it raises the question whether pension funds and other fiduciary investors are actually promoting the best interests of the beneficiaries of the funds they manage when they invest in activist funds, given the fact that activist funds promote short-termism with its attendant costs to the rest of the market and to the economy as a whole (see Leo E. Strine’s “One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates

Also Act and Think Long Term?" published in *The Business Lawyer* in November 2010). This month the UK Law Commission published a consultation paper responding to a government request, based on the Kay Review discussed below, "To evaluate whether fiduciary duties (as established in law or as applied in practice) [of investment intermediaries] are conducive to investment strategies in the best interests of the ultimate beneficiaries. We are asked to carry out this evaluation against a list of factors, balancing different objectives, **including encouraging long-term investment strategies** [emphasis supplied] and requiring a balance of risk and benefit."

Takeover Defenses and Firm Value

- Approaching the question from another perspective, William C. Johnson, Jonathan M. Karpoff and Sangho Yi investigated the impact of takeover defenses on firm value in "The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms" (April 29, 2013 working paper, available at http://papers.ssrn.com/abstract=1923667). Looking at a sample of 1,219 firms that went public between 1997 and 2005, the authors tested the "bonding hypothesis of takeover defenses"—that is, the theory that "takeover defenses increase the value of managers' commitments to maintain their promised operating strategy and not to opportunistically exploit their counterparties' investments in the IPO firm," which, "in turn, encourages the firm's counterparties to invest in the business relationship, yielding benefits for the IPO firm." The authors reported the following findings:

    1. IPO firms deploy more takeover defenses when they have large customers, dependent suppliers, or strategic partners;
    2. The IPO firm's value is positively related to its use of takeover defenses, particularly when it has large customers, dependent suppliers, and/or strategic partners;
    3. The IPO firm's subsequent operating performance is positively related to its use of takeover defenses, particularly when it has large customers, dependent suppliers, and/or strategic partners;
    4. When the IPO firm announces its intention to go public, its large customers experience a change in share values that is positively related to the IPO firm's use of takeover defenses; and
    5. After the IPO, the longevity of the IPO firm's business relationship with its large customer is positively related to its use of takeover defenses.

According to the authors, these results are explained by the fact that "takeover defenses … help to economize on the cost of building and maintaining value-increasing trading relationships between the IPO firm and its counterparties." As a result, "at IPO firms whose values depend heavily on their relationships with customers, suppliers, and strategic partners, takeover defenses appear to increase value by bonding the IPO firm's commitment to these relationships."

- In "The Impact of Antitakeover Amendments on Corporate Financial Performance" (published in *The Financial Review* in 2001), Mark S. Johnson and Ramesh P. Rao examined a sample of 649 antitakeover amendments adopted between 1979 and 1985 to determine the impact of the passage of antitakeover amendments on firm share price. Contrary to the management entrenchment hypothesis, the authors found that "antitakeover amendments are relatively benign events that do not significantly impact managerial behavior," and that "antitakeover amendments are not associated with deleterious effects to shareholders in terms of their impact on various fundamental firm performance measures."

Managerial Behavior and Pressures to Achieve Short-Term Performance

- Jie He and Xuan Tian's "The Dark Side of Analyst Coverage: The Case of Innovation" (forthcoming in the *Journal of Financial Economics*) examined the effect of analyst coverage on firm innovation to investigate how the pressure to achieve short-term performance impacts managerial behavior. The short-term pressures exerted by activist investors are often no different than those generated by stock analysts, and in many instances activist investors merely piggyback on stock analyst commentary when they launch attacks. Examining a sample of 25,860 firm-year observations relating to U.S. listed firms during the period of 1993-2005, He and Tian explored the "innovation output" of firms (as measured in terms of the number of (i) patent applications filed in a given year that are eventually granted and (ii) non-self citations each patent receives in subsequent years) in relation to the intensity of analyst coverage (as measured by the average number of earnings forecasts issued for the firm each month). The authors found that "an exogenous average loss of one analyst following a firm causes it to generate 18.2% more patents over a three-year window than a similar firm without any decrease in analyst coverage" and that "an exogenous average loss of one analyst following a firm leads it to generate patents receiving 29.4% more non- self citations than a similar firm without any decrease in analyst coverage." He and Tian determined that this evidence "is consistent with the hypothesis that analysts exert too much pressure on managers to meet short-term goals, impeding firms' investment in long-term innovative projects."

- Natalie Mizik published similar findings in “The Theory and Practice of Myopic Management,” featured in the *Journal of Marketing Research* in 2010. In this study, Mizik reviewed the operating performance, marketing spending, R&D spending and stock price performance of 6,642 firms between 1986 and 2005 to assess the financial consequences of the practice of cutting marketing and R&D spending to inflate short-term earnings. In order to isolate firms that were potentially engaging in “myopic management,” Mizik filtered for firms that simultaneously reported greater- than-normal profits, lower-than-normal marketing expenses and lower-than-normal R&D spending. Mizik then compared the stock performance of these “potentially myopic” firms against the performance of “nonmyopic” firms. Potentially myopic firms initially experienced much better stock performance than the firms that failed to meet performance expectations. However, after four years, “the portfolio of potentially myopic firms ha[d] a negative return of -15.7%, far below the return to the two nonmyopic benchmark portfolios (29.2% and 13.3%) and the S&P 500 return of 21.6%.” Mizik concludes that “[m]yopic management might have some short-lived benefits—it leads to higher current-term earnings and stock price—but it damages the long-term financial performance of the firm because the initial gains are followed by greater negative abnormal returns.”
- Aleksandra Kacperczyk’s “With Greater Power Comes Greater Responsibility?” (published in the *Strategic Management Journal* in 2009) tested the effect of takeover protection on the amount of corporate attention paid to shareholders and non-shareholding stakeholders, respectively. Looking at a sample of 878 firms between 1991 and 2002, Kacperczyk found that “an exogenous increase in takeover protection leads to higher corporate attention to community and the natural environment, but has no impact on corporate attention to employees, minorities and customers,” and that “firms that increase their attention to stakeholders experience an increase in long-term shareholder value,” measured over the two-year and three-year periods following the increase in takeover protection.
- Other empirical studies have shown that pressure from investors with short investment horizons can influence management to engage in financial misreporting. In “Institutional Ownership and Monitoring: Evidence from Financial Misreporting” (published in the *Journal of Corporate Finance* in 2010), Natasha Burns, Simi Kedia and Marc Lipson examined a sample of firms that restated their earnings between 1997 and 2002, finding that ownership by “transient institutions” (those with short investment horizons) are positively related with an increase in the likelihood and severity of an accounting restatement. The authors concluded that “[i]t is precisely these institutions, which trade frequently and therefore are likely to focus management attention on short- term reported performance, that provide incentives to manipulate earnings.”

- Another relevant study coming out of the financial crisis examined whether the corporate governance characteristics of banks impacted the likelihood of banks requiring government "bailout" support during the financial crisis. In "Shareholder Empowerment and Bank Bailouts" (a 2012 working paper), Daniel Ferreira, David Kershaw, Tom Kirchmaier and Edmund Schuster created a "management insulation" index ranking the degree of banks' management insulation based on their charter and by-law provisions and on the provisions of the applicable state corporate law that make it difficult for shareholders to oust management. They found that, in a sample of U.S. commercial banks, banks in which managers are "fully insulated" from shareholders were roughly 19 to 26 percentage points less likely to receive state bailouts than banks whose managers were subject to stronger shareholder rights. The authors explained that "[b]ank shareholders may have incentives to increase risk taking beyond the socially-optimal level" and that, "in search for higher returns, bank shareholders had incentives to push their banks towards less traditional banking activities."
- In his article "Do Institutional Investors Prefer Near-Term Earnings Over Long-Run Value?" (published in *Contemporary Accounting Research* in 2001), Brian Bushee examined a sample of 10,380 firm-years between 1980 and 1992 to determine whether institutional investors exhibit preferences for near-term earnings over long-run value. Bushee found that "the level of ownership by institutions with short investment horizons (transient institutions) and by institutions held to stringent fiduciary standards (banks) is positively (negatively) associated with the amount of value in near-term (long-term) earnings." Bushee found no evidence that banks "myopically price" firms by overweighting short-term earnings potential and underweighting long-term earnings potential. However, in transient institutions "high levels of transient ownership are associated with an over- (under-) weighting of near-term (long-term) expected earnings and a trading strategy based on this finding generates significant abnormal returns. This finding supports the concerns that many corporate managers have about the adverse effects of an ownership base dominated by short-term- focused institutional investors."
- The above result is consistent with an earlier empirical study by Bushee that examined the influence of shareholder demographics on earnings management by managers. In "The Influence of Institutional Investors on Myopic R&D Investment Behavior," published in the *Accounting Review* in 1998, Bushee investigated whether institutional investors create or reduce incentives for corporate managers to reduce investment in research and development to meet short-term earnings goals. Examining a sample of all firm-years between 1983 and 1994 with available data, Bushee found that "a high proportion of ownership by institutions exhibiting transient ownership characteristics (*i.e.*, high portfolio turnover, diversification, and momentum trading) significantly increases the probability

that managers reduce R&D to boost earnings." Bushee believed that "[t]his result supports the widely-argued view that short-term-oriented behavior by institutions creates pressures for managers to sacrifice R&D for the sake of higher current earnings" among those firms with high levels of transient ownership.

- William Pugh, Daniel Page and John Jahera, Jr.'s "Antitakeover Charter Amendments: Effects on Corporate Decisions" (published in the *Journal of Financial Research* in 1992) tested whether managers adopt a longer-term investment strategy after their firm passes antitakeover charter amendments. Examining a sample of firms that adopted antitakeover charter amendments between 1978 and 1985, the authors found that "firms increase spending on fixed capital as a percentage of both sales and assets the year of passage and for several years thereafter," and that overall results with respect to R&D expenditures "appear to support the managerial myopia hypothesis."
- A recent survey of 1,038 board members and executives by McKinsey & Company and the Canada Pension Plan Investment Board found startling levels of short-term orientation among corporate executives. As reported in the *Wall Street Journal*on May 22, 2013, this study found the following:
    - Sixty-three percent of business leaders indicated the pressure on their senior executives to demonstrate strong short-term financial performance has increased in the past five years.
    - Seventy-nine percent of directors and senior executives said they felt the most pressure to demonstrate strong financial performance over a time period of less than 2 years. Only 7% said they felt pressure to deliver strong financial performance over a horizon of 5 or more years.
    - However, respondents identified innovation and strong financial returns as the top two benefits their company would realize if their senior executives took a longer-term view to business decisions.
    - Yet, almost half of respondents (44%) said that their company's management team currently uses a primary time horizon of less than 3 years when they conduct a formal review of corporate strategy. Seventy-three percent said this primary time horizon should be more than 3 years and 11% said the horizon should be more than 10 years.
- The McKinsey findings are consistent with an earlier study published in the *Financial Analysts Journal* in 2006. In "Value Destruction and Financial Reporting Decisions," John Graham, Campbell Harvey and Shiva Rajgopal described the results of a survey of 401 senior financial executives. Going a step further than the McKinsey study, the authors asked executives if they would be willing to sacrifice long-term value in order to smooth

earnings. An “astonishing 78% admit[ted] they would sacrifice a small, moderate or large amount of value to achieve a smoother earnings path.”

Short-Termism and Macroeconomic Productivity

- The problems discussed above have larger implications than simply the performance of individual firms. In his 2012 book, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies*, Pavlos Masouros used macroeconomic data to show that the shift in corporate governance toward shareholder interests and increasing short-termism in France, Germany, the Netherlands, the UK and the US have contributed to low GDP growth rates in those countries since the early 1970s. Masouros outlined the unfolding of a “Great Reversal in Corporate Governance” whereby the primacy of shareholder value in the corporate governance pecking order was established, as well as a “Great Reversal in Shareholdership” where the average holding period of shares rapidly decreased, both of which contributed to a dramatic increase in the average equity-payout ratio of firms and a decrease in the average capital retention and reinvestment of profits by firms. Masouros’ prescription for ameliorating this trend away from capital reinvestment is what he calls “Long Governance”—moving toward a system where shareholders are infused with incentives that would allow them to develop long-term horizons that would align their interests with other constituencies and increase companies’ incentives to invest in future productivity.
- In “The Kay Review of UK Equity Markets and Long-Term Decision Making,” published by the UK Department for Business Innovation and Skills in July 2012 (the “Kay Review”), John Kay examined how the structure of the UK equity markets encourages short-termism and discussed the impact on UK businesses and investors. Kay started with the observation that “[a]s a percentage of GDP, research and development expenditure by British business has been in steady decline” and proceeded to explore why this was the case. He then identified a fundamental misalignment of the interests of the UK asset management industry and the ultimate principals, the companies which use equity markets and the individual UK “savers” who provide funds to them: “Returns to beneficial owners, taken as a whole, can be enhanced only by improving the performance of the corporate sector as a whole. Returns to any subset of beneficial owners can be enhanced, at the expense of other investors, by the superior relative performance of their own asset managers. Asset managers search for alpha, risk adjusted outperformance relative to a benchmark. But savers collectively will earn beta, the average return on the asset class.” This misalignment exists because “the time horizons used for decisions to hire or review investment managers are generally significantly shorter than the time

horizon over which the saver, or the corporate sponsor of a pension scheme, is looking to maximize a return." Kay pointed out that "[c]ompetition between asset managers to outperform each other by anticipating the changing whims of market sentiment … can add nothing, in aggregate, to the value of companies … and hence nothing to the overall returns to savers." Predictably, the short-term incentives of asset managers flow down to corporate managers, many of whom are incentivized "to make decisions whose immediate effects are positive even if the long run impact is not" and "whose consequences are likely to be apparent within a short time scale." After describing the problem in great detail, Kay presented a series of recommendations that he believed "will help to deliver the improvements to equity markets necessary to support sustainable long-term value creation by British companies," including the recommendation that "regulation must be directed towards the interests of market users —companies and savers—rather than the concerns of market intermediaries." The applicability of Kay's analysis to American equity markets is obvious.

The Evidence of Experience

No matter how much Professor Bebchuk attempts to denigrate what he calls "anecdotal" evidence, the experiences of those with "boots on the ground" must be taken into consideration in combination with the empirical evidence sampled above. Take, for example, some of the statements below from leaders who have firsthand experience with the short-term pressures faced by public company managers and directors.

- Bill George, a professor at Harvard Business School, former chief executive of the medical device company Medtronic, and currently a director of Goldman Sachs and Exxon Mobil, recently said in his August 2013 *New York Times* article, *Activists Seek Short-Term Gain, Not Long-Term Value*: "While activists often cloak their demands in the language of long-term actions, their real goal is a short-term bump in the stock price. They lobby publicly for significant structural changes, hoping to drive up the share price and book quick profits. Then they bail out, leaving corporate management to clean up the mess. Far from shaping up these companies, the activists' pressure for financial engineering only distracts management from focusing on long-term global competitiveness."
- Warren Buffet and 27 other highly regarded businesspeople, academics, investment bankers and union leaders expressed concerns about short-termism in "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management," a 2009 Aspen Institute policy statement. In this paper, these leaders voiced concern that "boards, managers, shareholders with varying agendas, and

regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation," and that this trend toward short-term objectives has "eroded faith in corporations continuing to be the foundation of the American free enterprise system." In particular, they noted that "the focus of some short-term investors on quarterly earnings and other short-term metrics can harm the interests of shareholders seeking long-term growth and sustainable earnings, if managements and boards pursue strategies simply to satisfy those short-term investors," which "may put a corporation's future at risk."

- Dominic Barton, global managing director of McKinsey & Company, described the problem in "Capitalism for the Long-Term," a 2012 McKinsey publication: "[E]xecutives must do a better job of filtering input and should give more weight to the views of investors with a longer-term, buy- and-hold orientation. … If they don't, short-term capital will beget short-term management through a natural chain of incentives and influence. If CEOs miss their quarterly earnings targets, some big investors agitate for their removal. As a result, CEOs and their top teams work overtime to meet those targets. The unintended upshot is that they manage for only a small portion of their firm's value. When McKinsey's finance experts deconstruct the value expectations embedded in share prices, we typically find that 70 to 90 percent of a company's value is related to cash flows expected three or more years out. If the vast majority of most firms' value depends on results more than three years from now, but management is preoccupied with what's reportable three months from now, then capitalism has a problem."
- Daniel Vasella, former chairman and CEO of Novartis AG, spoke firsthand about the pernicious effects of the pressure created by such short-term expectations in a 2002 *Fortune* article: "Once you get under the domination of making the quarter—even unwittingly—you start to compromise in the gray areas of your business, that wide swath of terrain between the top and bottom lines. Perhaps you'll begin to sacrifice things (such as funding a promising research-and-development project, incremental improvements to your products, customer service, employee training, expansion into new markets, and yes, community outreach) that are important and that may be vital for your company over the long term."

A Proposal for Effective Shareholder Engagement

In laying out the evidence above, I do not mean to say that all forms of investor engagement are bad. To the contrary, I believe that collaborative interaction between boards and long-term shareholders can help increase the effectiveness of boards. Consider the observations of John Kay in the Kay Review. Kay encouraged "effective engagement" between asset managers and the companies they invest in. However, he did not hold all forms of engagement equal, arguing

instead that all participants in the equity investment chain should act according to the principles of what he calls “stewardship”: “Our approach, which emphasizes relationships based on trust and respect, rooted in analysis and engagement, develops and extends the existing concept of stewardship in equity investment. This extended concept of stewardship requires that the skills and knowledge of the asset manager be integrated with the supervisory role of those employed in corporate governance: it looks forward to an engagement which is most commonly positive and supportive, and not merely critical.” Kay recommends that company directors “facilitate engagement with shareholders, and in particular institutional shareholders such as asset managers and asset holders, based on open and ongoing dialogue about their long-term concerns and investment objectives.” But, importantly, he also emphasizes that directors should “not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy.”

I support Kay’s views on what constitutes “effective engagement” and believe shareholder collaboration with management and directors along these lines could be a value- enhancing development for many companies both in the short-run and long-run.

Standing Firm, Not Running Away

As to Professor Bebchuk’s allegation, I think it is clear that, far from “running away” from the evidence, my views and my colleagues’ views are supported by many highly respected academics, policymakers, investors and business leaders whose empirical analyses and real-world experiences show that most activist interventions contribute to managerial short-termism and harm the innovation and growth potential of American companies. It is also clear that empirical evidence must be considered in context with other forms of evidence, including macroeconomic analysis, real-world experience and common sense, to determine if it tells a story that makes sense in the real world.

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Still Running Away from the Evidence: A Reply to Wachtell Lipton's Review of Empirical Work

Posted by Lucian Bebchuk, Harvard Law School, Alon Brav, Duke University, and Wei Jiang, Columbia Business School, on Wednesday March 5, 2014

Editor's Note: Lucian Bebchuk is Professor of Law, Economics, and Finance at Harvard Law School. Alon Brav is Professor of Finance at Duke University. Wei Jiang is Professor of Economics and Finance at Columbia Business School. This post responds to a Wachtell Lipton memorandum by Martin Lipton, Empiricism and Experience; Activism and Short-Termism; the Real World of Business, available on the Forum here. This memorandum presents a review of empirical work on activism and uses this review to criticize the empirical study by Bebchuk, Brav, and Jiang on The Long-Term Effects of Hedge Fund Activism. The study is available here, and its results are summarized in a Forum post and in a Wall Street Journal op-ed article. Bebchuk and Lipton will discuss the evidence on hedge fund activism at the Harvard Roundtable on Activist Interventions, which will take place later this month.

In a 17-page memorandum issued by the law firm of Wachtell Lipton (Wachtell), Empiricism and Experience; Activism and Short-Termism; the Real World of Business, the firm's founder Martin Lipton put forward new criticism of our empirical study, The Long-Term Effects of Hedge Fund Activism. Lipton's critique is based on a review of a large number of works which, he asserts, back up empirically the view that our study questions. Following our examination of each of the studies noted by Lipton, this post responds to Lipton's empirical review. We show that Lipton's review fails to identify any empirical evidence that is inconsistent with our findings or backs the claim of Wachtell that our study questions.

Our study shows that the myopic activisms claim that Lipton and his firm have long asserted—the claim that that interventions by activist hedge funds are in the long term detrimental to the involved companies and their long-term shareholders—is not supported by the data. Seeking to cast doubt on the validity of our finding, Lipton's memorandum cites twenty-seven works by academics or policymakers, and asserts that these studies demonstrate that our conclusion—that the myopic activism claims is not supported by the data—is "patently false." In this post, we explain that this assertion is not supported by the cited studies; most of the studies are not even

related to the subject of the consequences of hedge fund activism, and those that are related to it do not provide evidence contradicting our findings.

Below we begin with discussing the relevant background and then review the cited studies and explain why, in contrast to the impression Lipton's memo seeks to make, they do not provide an empirical basis for the myopic activists view. Instead of running away from the empirical evidence, while constantly shooting back, Wachtell Lipton should accept that its myopic activists claim is not supported by the data. Indeed, as one of us plans to discuss in a separate post, despite its repeated attacks on our study, Wachtell is shifting its position toward avoiding reliance on the myopic activism claim in its opposition to hedge fun activism, and this shift should lead Wachtell and its clients to rethink their attitude to hedge funds activists.

Background: The Wachtell Challenge and First Attempt to Run Away from the Evidence

Act I: The Wachtell Challenge

Wachtell has been a highly successful advisor to boards seeking to "defend vigorously" against interventions by activist hedge funds (see Wachtell's memo Dealing With Activist Hedge Funds for a brief outline of its approach). As part of its effort to put forward a policy basis for the opposition to hedge fund activism, Martin Lipton has long been an active advocate of the "myopic activism claim" concerning the detrimental long-term effects that activist interventions have for targeted companies and their shareholders.

In a debate that Martin Lipton had with Bebchuk last November, Bebchuk noted that he was engaged in a co-authored empirical study of the myopic activists claim. In his Bite the Apple memo, Martin Lipton issued in February a challenge for the research project that we were carrying out. He argued that "if Professor Bebchuk is truly interested in meaningful research to determine the impact of an activist attack," our research study should examine the following:

> "[F]or companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period."

We subsequently released an empirical study that met this challenge. Analyzing the full universe of approximately 2,000 interventions by activist hedge funds during the period 1994–2007, our study finds that the asserted long-term declines in shareholder wealth and operating performance are not supported by the data. (The results of our study are summarized in a post on the Forum here and in a WSJ op-ed article here.)

Act II: Wachtell Lipton's Initial Attack on Our Study

If Wachtell were "truly interested in meaningful research to determine the impact of an activist attack," it could have been expected to welcome the arrival of a study that provides a systematic analysis of the very kind it said would be worthwhile. Instead, it has been repeatedly attacking our study and, by contrast to its earlier view, casting doubt on the value of doing any subsequent empirical analysis of Wachtell's initial attack came in two memos, Current Thoughts about Activism and The Bebchuk Syllogism. These memos attempted to raise methodological questions about our findings and inferences. In a subsequent post, Don't Run Away from the Evidence: A Reply to Wachtell Lipton, we addressed these criticisms and showed that they are unwarranted and cannot provide a basis for Wachtell's appeals for disregarding our empirical findings and for relying on anecdotes and reported experiences.

Wachtell, however, did not give up; it came back with a new line of criticism.

The New Attack:

In addition to showing that the myopic activists claim is not supported by the data we study, our paper also notes that other work has also not provided empirical support for this claim. Lipton's new memo focuses not on what we do in our study but on our assessment that there is currently no empirical support for the myopic activisms claim. Lipton marshals a large number of works that, Lipton asserts, provide empirical backing to the myopic activists claim and thereby demonstrate that our assessment is "patently false." However, as detailed below, despite the large number of works reviewed by Lipton, he fails to identify a single paper that provides evidence that interventions by activist hedge funds are followed in the long term by declines in shareholder wealth or operating performance.

In particular, Lipton's review cites seven works that do not provide any empirical evidence but only discuss empirical work by others; sixteen papers that provide empirical evidence on corporate governance topics other than the aftermath of activist interventions and thus do not speak to the empirical validity of the myopic activist claims; and four works that empirically examine the aftermath of activist interventions but do not contradict our findings or show the validity of the myopic activists claim. We discuss these three categories of cited works below. (In string citations below, we list works cited in the order in which they are cited in the course of the Lipton review.)

Non-empirical papers:

Seven of the works cited by Lipton—Dallas (2012), Bair (2011), Macey and Buckberg (2009), Romano (2001), Masouros (2012), Kay (2012), and Strine (2010)—do not themselves provide empirical evidence but rather discuss or note empirical work by others. These studies thus cannot be regarded as providing themselves any empirical evidence regarding the validity of the myopic activists claim.

Empirical paper on issues other than the aftermath of activist interventions:

The majority of the papers cited by Lipton are empirical papers in the corporate governance area that focus on issues other than what follows activists interventions or, as Lipton put it, "[F]or companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark … after a 24-month period." In particular, Lipton cites the following sixteen studies on other corporate governance topics:

- Five papers—Wahal (1996), Dos Santos and Song (2008), Ingraham and Koyfman (2013), Prevost and Rao (2000), and Karpoff, Malatesta and Walkling (1996)—that present empirical analyses of precatory shareholder proposals under rule 14a-8; hedge fund activists generally do not submit such precatory proposals and activism via the submission of such precatory proposals is significantly different from hedge fund activism.
- Five papers—Johnson, Karpoff and Yi (2013), Johnson and Rao (2001), Kacperczyk (2009), Ferreira, Kershaw, Kirchmaier and Schuster (2012), and Pugh, Page and Jahera (1992)—present an empirical analysis of the association between antitakeover provisions, which insulate boards from shareholder intervention, and corporate outcomes.
- Three works—Burns, Kedia and Lipson (2010), Bushee (2001), and Bushee (1998)—present economic analyses of the relationship of the investment horizons of investors (most of which are mutual funds and not hedge fund activists) with corporate outcomes and behavior.
- Two papers—Mizik (2010) and Graham, Harvey and Rajgopal (2006)—focus on myopic decisions by insiders, which might be due to factors other than hedge fund activism such as short-term pay packages.
- Finally, one work—He and Tian (2013)—focusses on the association between coverage by stock analysts and innovation.

Some of the above studies could be relevant for assessing alternative grounds for the insulation of boards that Lipton advocates. For example, even if interventions by activist hedge funds have beneficial consequences, to the extent that the mere fear of such interventions leads insiders to engage in detrimental short-termism, and the relationship between antitakeover provisions and firm value is worth examining. While reviewing the relationship between antitakeover provisions and firm value is beyond the scope of this post, one of us conducts such a review elsewhere (see The Myth that Insulating Boards Serves Long-Term Value, section III.C) and shows that, overall, the evidence is consistent with the view that antitakeover provisions are associated with lower firm value and worse firm performance. For the purposes of this post, however, the critical point is that studies concerning the relationship between antitakeover provisions and corporate outcomes, as well as the other studies listed above, do not provide empirical evidence on the validity of the myopic activists claim.

Empirical studies on the aftermath of activist hedge fund interventions:

Finally, Lipton refers to three empirical papers that focus on the aftermath of interventions by hedge fund activists, with three of these studies published in the first half of the 1990s and analyze data from the 1980s and the 1970s:

- Ikenberry and Lakonishok (1993), which examine proxy contests during 1968-1988;
- Fleming (1995), which examines actual and threatened proxy contests during 1977-1988; and
- Borstadt and Zwirlein (1992), which examines proxy fights during the period 1962-1986.

These studies thus focus on activism in an earlier era—the area of hostile takeovers in which, unlike activist efforts in the past two decades, dissident efforts were largely focused on facilitating a takeover. Moreover, a close review of the above three studies indicates that even these studies do not support Wachtell's negative view of dissident activity in general. For example, while Fleming (1995) identifies a subset of contests with negative abnormal returns, he documents "shareholder value gains in the full sample of proxy contests" that the study shows to be long-lasting. Finally, and importantly, we note that a recent study of proxy contests (Fos (2013)) examines data from the current era and reaches conclusions that support activism.

In addition to the above studies from the first half of the 1990s using 1980s and 1970s data, Lipton notes one paper that focuses on hedge fund activism in the modern era—Greenwood and Schor (2009). This study does not question that activism on average increases shareholder wealth but only suggests that those gains are driven by companies that are acquired. Moreover, the study does not examine the effect of activism on operating performance, and thus cannot

does not contradict our finding that companies that remain independent have 3, 4, and 5 years out operating performance that is superior to the performance at the time of the intervention.

While Lipton includes in his review even a significant number of unrelated papers and three papers on hedge fund activism from the first half of the 1990s, he fails to include in his review several recent papers on hedge fund activism on the modern era. These papers (some of which are widely cited) include Brav et. al. (2008), Boyson and Mooradian (2009), Clifford (2008), Klein and Zur (2009), Brav et. al. (2009), Becht et. al. (2009), and Brav et. al. (2013). None of these papers provides evidence supporting Lipton's myopic activists claim.

The Continuing Appeal for Reliance on the view of Corporate Leaders and Advisers

While most of Lipton's memorandum is devoted to throwing at us a large citations to other academic works, Lipton concludes by repeating the appeal he made in his earlier memos criticizing our study for placing substantial weight on the reported experience of corporate leaders and advisers.

In our earlier response post, we pointed out that the reported experiences on which Lipton is willing to rely seem to be ones from company leaders and their advisors. He does not seem to be willing to place any reliance on the reported experience of the leaders of hedge fund and their advisors, which are also sometimes made with confidence and passion. We stressed in our earlier response post that economists commonly prefer objective empirical evidence over unverifiable reports of affected individuals. Moreover, with respect to the myopic activists claim, given that shareholder wealth and operating performance can be measured using standard databases, the claim can be subject to a direct and rigorous and empirical testing. Thus, there is little reason to rely on the reported impressions of corporate leaders and advisors.

In sum, the examination of empirical studies noted in Lipton's recent review, which fails to identify a single study that documents that activist interventions tend to be followed by declines in shareholder wealth and operating performance, highlights that it is untenable for Wachtell to continue asserting that its myopic activists claim is backed by empirical evidence. This claim is not backed by the evidence.