

August 26, 2013

The Bebchuk Syllogism

*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](#)." 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.

*If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to [Publications@wlrk.com](mailto:Publications@wlrk.com) or call 212-403-1424.*

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."

Martin Lipton  
Steven A. Rosenblum  
Eric S. Robinson  
Karessa L. Cain  
Sabastian V. Niles