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UPDATED

Recognition of the Threat to Shareholders and the Economy from Attacks by Activist Hedge Funds

Again in 2014, as in the two previous years, there has been an increase in the number and intensity of attacks by activist hedge funds. Indeed, 2014 could well be called the "year of the wolf pack."

With the increase in activist hedge fund attacks, particularly those aimed at achieving an immediate increase in the market value of the target by dismembering or overleveraging, there is a growing recognition of the adverse effect of these attacks on shareholders, employees, communities and the economy. Noted below are the most significant 2014 developments holding out a promise of turning the tide against activism and its proponents, including those in academia. **Already in 2015 there have been several significant developments that are worth adding, which are included in bold at the end.**

- Several institutional investors voiced concerns about activism this year, including Laurence Fink of BlackRock – first in March lamenting the cuts to capital expenditures and increased debt used to fuel dividends and share buybacks, which he views as having the potential to "jeopardize a company's ability to generate sustainable long-term returns," and then in December stating that "[s]trategies pursued by activist investors 'destroy jobs.'"

- Tim Armour of Capital Group criticized the recent wave of share buybacks, explaining that "[w]e think companies should be run for the long-term and do not think forced steps should be taken to maximize short-term profits at the expense of having thriving enterprise."

- William McNabb of Vanguard spoke out against the standard activist playbook of aggressively criticizing companies once problems emerge and endorsed a more low-key approach of engagement between directors and shareholders aimed to prevent problems before they happen.

- James Montier of GMO Capital presented compelling empirical evidence that, as Jack Welch once said, shareholder value maximization is "the dumbest idea in the world," and demonstrating that, ironically, it has not benefitted shareholders themselves.

- Even activists themselves began to acknowledge how outlandish some of their stunts are; Jeffrey Ubben of ValueAct, for example, who favors a more behind-the-scenes, constructive style of activism, likened certain recent actions by other activists to "greenmail," called certain activist tactics "corrupt" and accused one activist in particular of simply "entertaining himself."

- In December, the Conference Board released a must-read presentation entitled "Activists and Short Term Corporate Behavior" that compiles data demonstrating that capital investment by U.S. public companies has decreased (and is less than that of private companies), that short-term pressures are increasing and that hedge fund activism results not in the creation of value but in transfers of value from employees and bondholders to shareholders.

- William Galston's editorial in the *Wall Street Journal*, "'Shareholder Value' Is Hurting Workers: Financiers Fixated on the Short-Term Are Forcing CEOs into Decisions That Are Bad for the Country," as the title suggests, warned that activism is harming workers (pointing to the recent break-up of Timken as a prime example) and that if short-termism prevails, "we won't have the long-term investments in workers and innovation that we need to sustain a higher rate of growth."

- Dominic Barton, the global managing director of McKinsey, and Mark Wiseman, the president and CEO of the Canada Pension Plan Investment Board, joined to author an article in the *Harvard Business Review*, "Focusing Capital on the Long Term," which suggests practical steps that major asset owners such as pension funds, insurance firms and mutual funds can take to minimize the detrimental effects of increased pressure from financial markets and the resulting short-termism, which they believe has "far-reaching consequences, including slower GDP growth, higher unemployment, and lower return on investment for savers."

- A federal court in California found "serious questions" as to whether Valeant and Pershing Square violated the federal securities laws in connection with their joint hostile bid for Allergan and thereby, as a practical matter, put an end to this scheme until the issue is resolved.

- SEC Commissioner Daniel Gallagher and former Commissioner (and current Stanford Law Professor) Joseph Grundfest argued that the push for board declassification by Harvard Law School's Shareholder Rights Campaign, initiated by Professor Lucian Bebchuk, was not only based on shoddy scholarship, it actually violated federal securities law antifraud rules.

- SEC Commissioner Gallagher also called for much-needed reforms to Rule 14a-8 to "ensur[e] that activist investors don't crowd out everyday and long-term investors" by repeatedly bringing costly shareholder proposals (notwithstanding prior failures) that have little or no connection to company value.

- The SEC took a step toward limiting uncritical reliance on proxy advisory firms by issuing guidance indicating that, to fulfill their fiduciary duties to clients, investment advisers must establish and implement measures reasonably designed both to provide sufficient ongoing oversight of proxy advisory firms and to identify and address such firms' conflicts of interest **and errors in their voting recommendations**.

- Economics Professor William Lazonick argued that share buybacks can boost share prices in the short term but ultimately disrupt income equality, job stability and overall economic growth, and research by Barclays cited in a *Financial Times* article called "Buybacks: Money Well Spent?" provided empirical support showing that the "buyback bonanza" indeed contributed to slower growth, including lower earnings retention not reflected in price-to-book value.

- A paper by Dr. Yvan Allaire entitled "The Value of 'Just Say No,'" and also memos by our firm (here and here), demonstrated that an ISS client note entitled "The IRR of No," which argued that companies that had "just said no" to hostile takeover bids incurred profoundly negative returns, suffered from critical methodological and analytical flaws that undermined its conclusions.

- Dr. Allaire also presented sophisticated **analyses** contained in **three** papers ("Activist Hedge Funds: Creators of Lasting Wealth? What Do the Empirical Studies Really Say?"; "Hedge Fund Activism and Their Long-Term Consequences; Unanswered Questions to Bebchuk, Brav and Jiang"; **and in 2015 "Still unanswered questions (and new ones) to Bebchuk, Brav and Jiang"**), consistent with our firm's earlier observations, offering a devastating critique of Professor Bebchuk's research claiming to show that attacks by activist hedge funds did not destroy long-term value.

- The argument made by Professor Bebchuk, together with Professor Robert Jackson, that poison pills were unconstitutional was similarly dismissed (some would say derided) as the grasping-at-straws argument that it was and one wholly inconsistent with existing case law.

- Delaware Supreme Court Chief Justice Leo Strine, Jr.'s *Columbia Law Review* article, "Can We Do Better By Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law," persuasively argued against allowing investment funds to prevail over the carefully considered judgments of boards of directors and at the expense of the long-term interests of the ultimate beneficiaries whose assets such funds manage.

- In an article entitled "The Impact of Hedge Fund Activism: Evidence and Implications," Columbia Law School Professor John Coffee, Jr. rejected the so-called empirical evidence that Professor Bebchuk uses to "prove" that activist attacks are beneficial, and proposed various potential reforms and private ordering techniques (such as a "window-closing" poison pill) that could help mitigate activism's pernicious effects.

- In "How to Outsmart Activist Investors," Professors William George and Jay Lorsch of the Harvard Business School advised companies on how to fend off activist challenges, writing that they "remain unconvinced . . . that hedge fund activism is a positive trend for U.S. corporations and the economy."

- Leiden University Professor Pavlos Masouros, in his book entitled *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies*, convincingly outlined the chain of political, economic and legal events that led to the shift from a "retain and invest" corporate strategy to a "downsize and distribute" mentality, and the consequent stagnation in GDP growth.

- Cornell University Law School Professor Lynn Stout also published a book that challenges the ideology of shareholder value maximization, the title of which speaks for itself: *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*.

- Oxford University Professor Colin Mayer's *Firm Commitment: Why the Corporation Is Failing Us and How to Restore Trust in It* set forth a new paradigm for thinking about corporations, in part to solve the "increasing[] difficult[y] for directors to do anything other than reflect what is perceived to be in the immediate interests of their most influential, frequently short-term shareholders."

- The Delaware Court of Chancery, in *Third Point LLC* v. *Ruprecht*, confirmed the legitimacy of the use of poison pills – not only in the face of an inadequate takeover offer – but also in response to an activist threat.

- **State Street Global Advisors issued an issuer engagement protocol that is intended to enable State Street to better understand issuers' business strategy, management and operations. Hopefully, this will result in State Street supporting issuers' long-term investment goals and mitigate exposure to activists' short-term demands.**

- **Vanguard reviewed their proxy voting and engagement efforts, emphasizing an approach to governance characterized by "quiet diplomacy focused on results," in which voting decisions are made based on "its own analysis, not the recommendations of third parties" and direct discussions with companies are prioritized to "permit a more nuanced and precise exchange of views than the blunt instrument of a shareholder vote."**

- **Two prominent former JP Morgan deal makers announced the formation of Hudson Executive Capital, which they described as a new type of activist hedge fund that will collaborate with companies and their boards. The announcement stated that Hudson will**

not conduct proxy fights or issue poison-pen letters. Their goal appears to be to have Hudson recognized as a traditional merchant bank and not an activist hedge fund.

- **Well-known Yale School of Management Professor Jeffrey Sonnenfeld in an article in the January/February issue of *Chief Executive* said, "Vigilant CEOs have a right, and even a duty, to resist self-motivated activism that adds nothing. It's worth noting that it wasn't so very long ago that investors who resorted to such antics were called by the less salubrious term 'green mailers.'"**

- **Guhan Subramanian, a Professor at both Harvard Law School and Harvard Business School and a long-time protégé-colleague of Lucian Bebchuk, has written an article for the March issue of the *Harvard Business Review* advocating a new form of corporate governance that reflects a need to "return to first principles rather than meander toward 'best practices.'" His first principle is that "Boards Should Have the Right to Manage the Company for the Long Term." His other recommendations are (1) replacing quarterly earnings guidance with long-term goals, (2) accepting staggered boards if they can be overcome by a shareholder-approved takeover bid, (3) accepting exclusive forum bylaws, (4) instituting meaningful board evaluation but no director age or term limits, and (5) giving shareholders an "orderly" voice.**

We hope that the growing recognition of the analytical and methodological defects in the so-called empirical evidence put forward to justify activist hedge fund attacks by Professor Bebchuk and his cohorts and the growing recognition, not just in the business community, but in academia as well, of the serious threat of activism and short-termism to employees, communities and the economy will result in further action by responsible institutional investors to deny support to activist hedge funds and will also result in legislative, regulatory and judicial actions to dampen their abuses and lessen substantially their impact.

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