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Activist Directors and Agency Costs

By John C. Coffee, Jr.*

1. **This is a methodologically dense article (for which I apologize), but it has some important conclusions, which I will highlight at the outset.**

2. **First, however, one concession: although I probably wrote the majority of the words on the page in this article, I am the lone author who is not a professional empiricist. The others concentrate in this area, and thus I will avoid any debate over methodology.**

3. **What do we find happens when activist investors place one or more nominees on the board of a public corporation in the U.S.?**

   Answer: Three Key Findings!

4. **First, once an activist-nominated director goes on the board, an abrupt increase in "information leakage" follows -- with the result that the target corporation's stock price begins to anticipate future public disclosures. Basically, we study the market's reaction (both before and after) to the filing of Form 8-Ks, which are unscheduled filings made by**

* Professor Coffee is the Adolf A. Berle Professor of Law at Columbia University Law School and Director of its Center on Corporate Governance.

issuers with the SEC to disclose new and usually material information. Using control groups for each such company over the period from 2000 to September 30, 2016, we find that (1) once the activist goes on the board, the market is better able to estimate the impact of the Form 8-K before it is filed and (2) target firms experience a comparative increase in this leakage of 25 to 27 percentage points.

5. **More surprising by far, we find that this increase in information leakage depends on (and is driven by) the identity of the actors. First, only hedge fund activists appear to produce this impact (not other institutional investors). Second, leakage depends heavily on the identity of the director appointed to the target board. We find that the increase in leakage is closely associated with the appointment of a hedge fund employee to the target board and is not associated with the appointment of other persons, such as industry professionals and retired CEOs).**

6. **Here, I need to explain that only about 27% of activist nominees for the board are hedge fund employees, but about two/thirds of activist slates (typically one to three) contain at least one nominee who is a hedge fund employee. Often this nominee is the CEO or founder of the hedge fund.**

7. **<u>Second Big Finding</u>: Leakage is also associated with an absence of confidentiality provisions that restrict information sharing by the activist investors. The majority of the settlement agreements that we study have no confidentiality provisions, and information leakage is concentrated in these cases.**

8. **<u>Third Finding: Market Reaction to Settlement Agreement</u>. Contests between activist investors and target managements rarely result in a proxy battle in which all shareholders get to vote. In 2016, for example, 95% of the seats on boards won by activists were obtained through private settlement agreements, not public proxy fights. Because target managements are risk averse, managements prefer a settlement to a fight in which they could be ousted. In these settlements, target managements on average concede board seats to 1.76 fund-nominated directors.**

9. **What is the stock market reaction to these settlement agreements? We assemble a data set of 475 such settlement agreements and find the following:**

   (a) **The five day CAR is more than twice as high (4.2% vs. 1.97%) for settlements in which only non-employees of the hedge funds are appointed to the board. Even a greater disparity separates the market's reaction to settlement agreements that**

contain an explicit restriction on information sharing from those that say nothing on this score (2.02% vs. 0.42%).

(b) Bid-ask spreads increase by a statistically meaningful amount once activist investors gain a representative on the target board pursuant to a settlement agreement. Further, we find that increases in the bid-ask spread are concentrated in those cases where (1) a hedge fund employee is appointed to the board or (2) no confidentiality provision is referenced in the settlement agreement.

(c) Options trading increases significantly after an activist nominee is appointed to the board. This is the traditional sign that the market expects informed trading.

10. <u>What Explains This Pattern</u>? The most plausible explanation for these inter-linked phenomena - - i.e., (1) the market's much more positive response to activist slates that do not contain a hedge fund employee, (2) the widening of the bid-ask spread when an employee is on the slate, (3) the growth in options trading and (4) most of all, the seeming incorporation of material information into the market price prior to its public disclosure - - is that a substantial amount of informed trading occurs once a hedge fund employee goes on the board as the result of a settlement agreement. Increases in the bid-ask spread are a

standard reaction when professional dealers suspect that they are dealing with an informed trader. Moreover, it appears not only that such informed trading is occurring (first in the options market), but that the market expects it (and so widens the bid-ask spread). That the market reacts twice as positively to director slates without a hedge fund employee is further evidence that the other shareholders are being subjected to a new agency cost: informed trading by activist investors with seats on the board.

11. <u>Why Do We Care</u>?

(a) Some have responded to this evidence by essentially saying: "So what? There is always some informed trading occurring and here it is going to those who are desirably disciplining target management."

(b) But this reply ignores that the profits made from informed trading essentially result in a subsidy to activists that encourages them to engage target firms and seek seats on their boards. More, rather than less, activist engagements predictably follow if such a subsidy from informed trading is tolerated.

(c) There is also a second reason why we may care: transparency and shareholder democracy are injured (and, to an extent, eclipsed) when privately negotiated

settlement agreements, rather than open shareholder votes, determine the composition of the board.

12. Does The End Really Justify The Means?

Arguably, informed trading by those with representatives on the board is undesirable even if it did accomplish an efficient outcome. But does hedge fund activism really enhance the efficiency of the target firms?

Early studies, several by Harvard Professor Lucian Bebchuk, suggested that it did. But the last two years have seen a major counter-reaction. In 2018, Professor Martin Cremers and others contended that Professor Bebchuk failed to properly use a control group and, once such a group was properly used, a regression to the mean can be seen in the subsequent performance of activist targets. In 2019, Ed deHann, David Larcker of Stanford and Charles McClure of Chicago found that under their revised methodology (which uses value-weighting rather than equal weighting), the long-term returns to activism were "insignificantly different from zero." Even in the case of an equal weighing method, the positive results were driven only by the smallest 20% of firms (with an average market value of $22 million). This debate will likely continue, but, even if we were to accept

that the end can justify the means, there is grave doubt that any long-term economic or social gain results from hedge fund activism.

13. Where Has Our Study Been Criticized?

From the very outset of our study, we have faced the objection that firms subject to an activist engagement are very different than other firms and so our control groups do not work. We have attempted to respond to this criticism in several ways:

First, we must point that the sharp difference in information leakage depending on whether an activist slate contains a hedge fund employee does not need a control group (nor does the strong evidence that the market reacts more favorably to slates without a hedge fund employee).

Second, we developed an alternative control group test consisting of firms that experienced a Schedule 13D filing but did not engage in a settlement agreement with the activist investors. These firms are also undergoing a hedge fund engagement seeking operational and other changes as a result of hedge fund pressure. The results with these alternative control groups are consistent with our earlier results (see pages 425-426 of

article); the same pattern of information leakage is stronger in cases where a hedge fund employee goes on the board.

Third (and this was my addition), we look within our treatment group (i.e., those firms that are engaged by activists and reach a settlement agreement) and compare information leakage after the filing of a Schedule 13D (but before the appointment of the activist directors) with leakage after the appointment of these fund-nominated directors (see pages 427-428). Again, we find a statistically significant increase in information leakage after the directors are appointed.

These results show that the increase in information leakage is not driven simply by the activist engagement alone but seems much more attributable to the appointment of directors pursuant to the settlement agreement.

14. <u>Conclusion</u>.

Hedge fund activism appears closely associated with informed trading. This trading may or may not be unlawful, but it is in virtually all cases an agency cost born by the other shareholders. Who are the direct beneficiaries of this trading remains uncertain. Even if it is only the tippees of hedge fund employees, such tipping may serve an important purpose

of activist investors: namely allowing them to assemble a larger "wolf pack" of allies and thus place target management under greater pressure.

15. Further Research.

Joined by still another financial economist (Darius Palia), our team is continuing our research and now have a later data set. We are finding that the highest levels of information leakage are associated with smaller (and younger) activist hedge funds. Still, even the mean activist in our new and expanded data set appears to be "leaky." Various interpretations can be given to this finding, including that smaller activists may need to assemble a larger "wolf pack" of allies to be credible.

Stay tuned! We will have a new study in due course.