

Activist Directors and Agency Costs: What Happens When Activists Go on the Board?

Robert Bishop, John Coffee, Robert Jackson* and Joshua R. Mitts
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Introduction

This paper offers a theoretical and empirical contribution to the growing literature on shareholder activism.

- A great deal of attention has been given to the agency-cost-reducing benefits of shareholder activism (Brav et. al., 2008; Bebchuk, Brav, and Jiang, 2015), along with potential deleterious effects of activist interventions (Lipton et al., 2013, Coffee & Palia, 2015).
- In light of these debates, policymakers are currently considering significant changes to the securities law governing these investors (Wachtell, Lipton, Rosen & Katz, 2011; Bebchuk & Jackson, 2012).
- Today, most activist interventions conclude with a settlement agreement between the target board and the activist (Bebchuk, Brav, Jiang, and Keusch (2017); Schoenfeld (2017)).
- Contributing to this prior work, we introduce an extended dataset of such settlements, theory for understanding how they work, and evidence on their effects for public-company shareholders.

A Sample Activist Settlement

Today, more than half of activist engagements conclude in a settlement agreement of this type.

SUPPORT AGREEMENT

This Support Agreement, dated November 20, 2014 (this "Agreement"), is by and among (i) Third Point LLC, Third Point Partners Qualified L.P., Third Point Partners L.P., Third Point Offshore Master Fund L.P., Third Point Ultra Master Fund L.P. and Third Point Reinsurance Co. Ltd. (collectively, "Third Point", and each individually, a "member" of Third Point) and (ii) The Dow Chemical Company (the "Company")

WHEREAS, Third Point . . . beneficially owns 27,500,000 shares of common stock of the Company, par value \$2.50 (the "Common Stock") of the Common Stock issued and outstanding on the date hereof

1. Board Representation and Board Matters.

(a) The Company and Third Point agree as follows:

(i) the Board shall take all action necessary (A) to increase the size of the Board by three directors to 13 directors, effective as of January 1, 2015, and (B) to appoint each of Robert Steven Miller and Raymond J. Milchovich (collectively, the "Designees") and Mark Loughridge to serve as directors of the Company, effective as of January 1, 2015, until the later of (1) the 2015 Annual Meeting and (2) the date that their successors are duly elected and qualified, subject to the terms of this Agreement;

(ii) the Company's slate of nominees for election as directors of the Company at the Company's 2015 Annual Meeting shall include (A) the Designees, (B) Mark Loughridge, (C) Richard Davis, who will replace a then-current director, other than the Designees and Mark Loughridge, and (D) no more than nine other nominees identified and approved by the Governance Committee and the Board

2. Certain Other Matters. . . .

(c) During the Standstill Period, no member of Third Point shall, directly or indirectly (it being understood that any actions taken by Daniel S. Loeb shall be deemed to be actions taken by Third Point)[:]

(i) solicit proxies or written consents of stockholders or conduct any other type of referendum (binding or non-binding) with respect to, or from the holders of, the Voting Securities (as defined below), or become a "participant" (as such term is defined in Instruction 3 to Item 4 of Schedule 14A promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) in or assist any person or entity not a party to this agreement (a "Third Party") in any "solicitation" of any proxy, consent or other authority

(xi) purchase or cause to be purchased or otherwise acquire or agree to acquire Beneficial Ownership of any Voting Securities, if in any such case, immediately after the taking of such action, Third Point would, in the aggregate, collectively beneficially own, or have an economic interest in, an amount that would exceed 4.99% of the then outstanding shares of Common Stock

Activists obtain their chosen nominees' seat on the board

. . . . While incumbent directors halt the activist's attack.

We extract the terms of more than 500 of these settlements over a 15-year period—and information on disclosure of new corporate events at activist targets.

- We extract from 514 settlement agreements executed between 2000 and 2015 detail on when the activist's director gains access to the boardroom, the characteristics of the director, whether the activist is a hedge fund, pension fund, or other institution, and other characteristics of the agreement.
- We then construct a sample of 672,158 disclosures, on Form 8-K, of material corporate events by 7,852 public companies between January 1, 2000 and September 30, 2016.
- We merge these samples to evaluate the effects of these directors on how information about these events makes its way into stock prices.

Summary Statistics

Let's begin with a sense for what we see in these agreements descriptively.

Settlement Terms	Number of Observations	% of Overall Sample
Average Number of Board Seats Acquired by Activist	1.76	(—)
Activist Directors Granted Observer Rights in Advance of Appointment	37	7.8%
New Director Group Includes Activist Employee	331	69.8%
Agreement Includes Publicly Disclosed Standstill	263	55.4%
Average Standstill Length (In Annual Meetings)	1.47	(—)
Agreement Calls for Reimbursement of Activist Expenses	147	30.9%

Preliminary Analysis: Cumulative Abnormal Returns

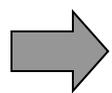
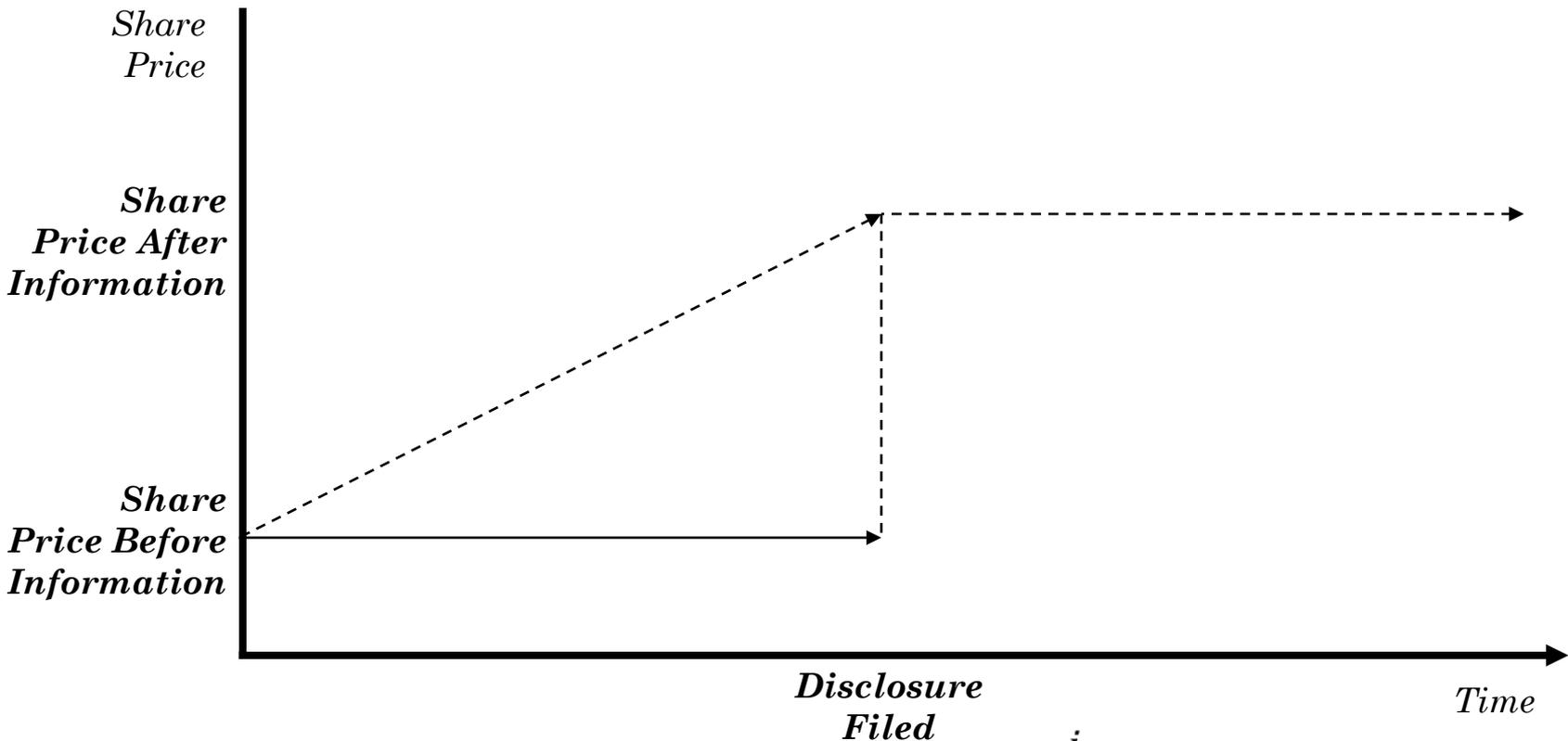
We confirm—but add more subtlety to—previous findings on CARs around the announcement of activist interventions.

- First, we confirm in our dataset the famous result of Brav, Jiang, Partnoy, and Thomas (2008) that the announcement of an activist campaign is followed by statistically significant positive CARs.
- Second, we confirm the finding of Bebchuk, Brav, Jiang, and Keusch (2017) that the announcement of an activist *settlement* agreement is accompanied by statistically significantly positive CARs (in both their sample and ours, which extends to 2015).
- We identify, however, important heterogeneity in that result:
 - Average 5-day CAR is more than twice as high (4.2% vs. 1.9%) for settlements involving appointments of activist directors who are not hedge-fund employees; and
 - Average 5-day CAR is far higher (2.2% vs. 0.04%) for settlements with an explicit rule on information sharing in the agreement.

Information “Leakage,” Defined

This idea motivates our principal measure of how information makes its way into stock prices.

We measure as a ratio between price changes in the four days before the disclosure and the price change in the five days that include the day of disclosure:



Or, as in Jackson, Jiang, and Mitts (2016):

$$leak_{i,t} = \frac{r_{t-5,t-1}^i}{r_{t-5,t_0}^i}$$

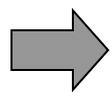
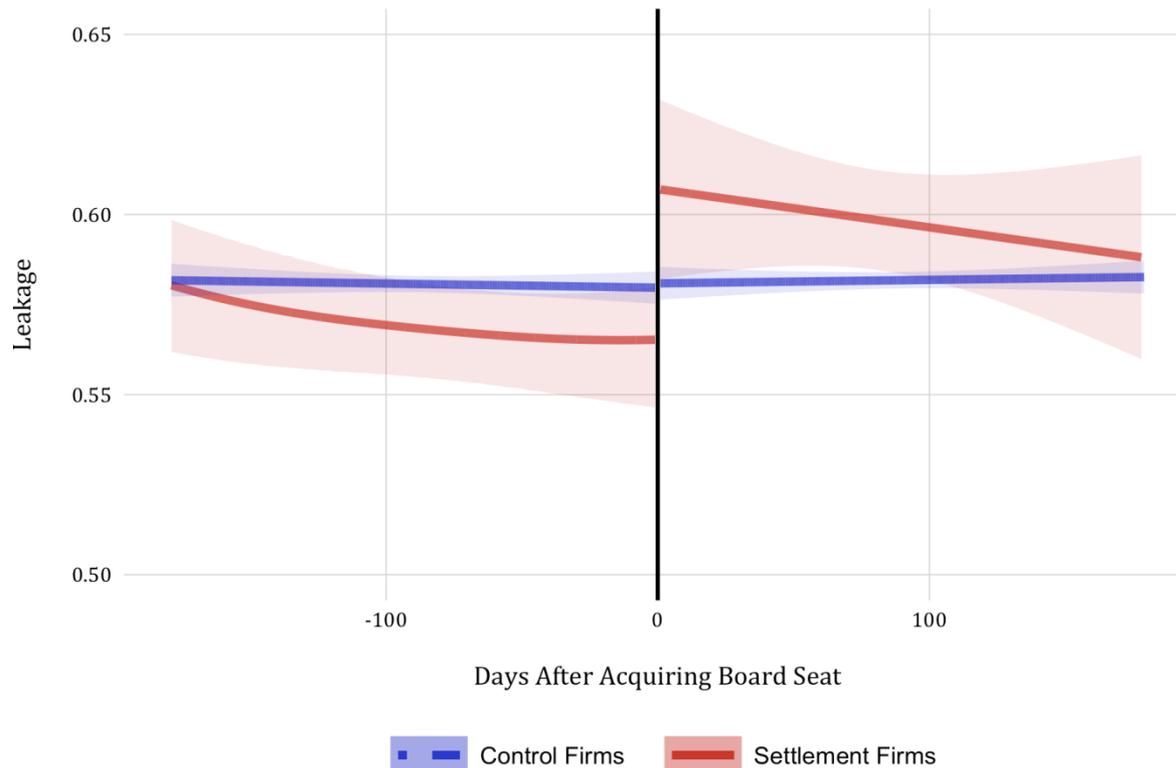
Our Design

We use a difference-in-differences design to isolate the effects of giving an activist director access to the boardroom.

- This design compares the change over time in our “treatment” group (firms where the activist places a director on the board) with the change over time in a control group of public companies.
- The key assumption behind any difference-in-differences design is that the treatment and control groups follow parallel trends through time before the treatment event.
- We verify this empirically with statistical balance tests, but we think the most convincing evidence is in the following graph.

Our Findings: Activist Leakage

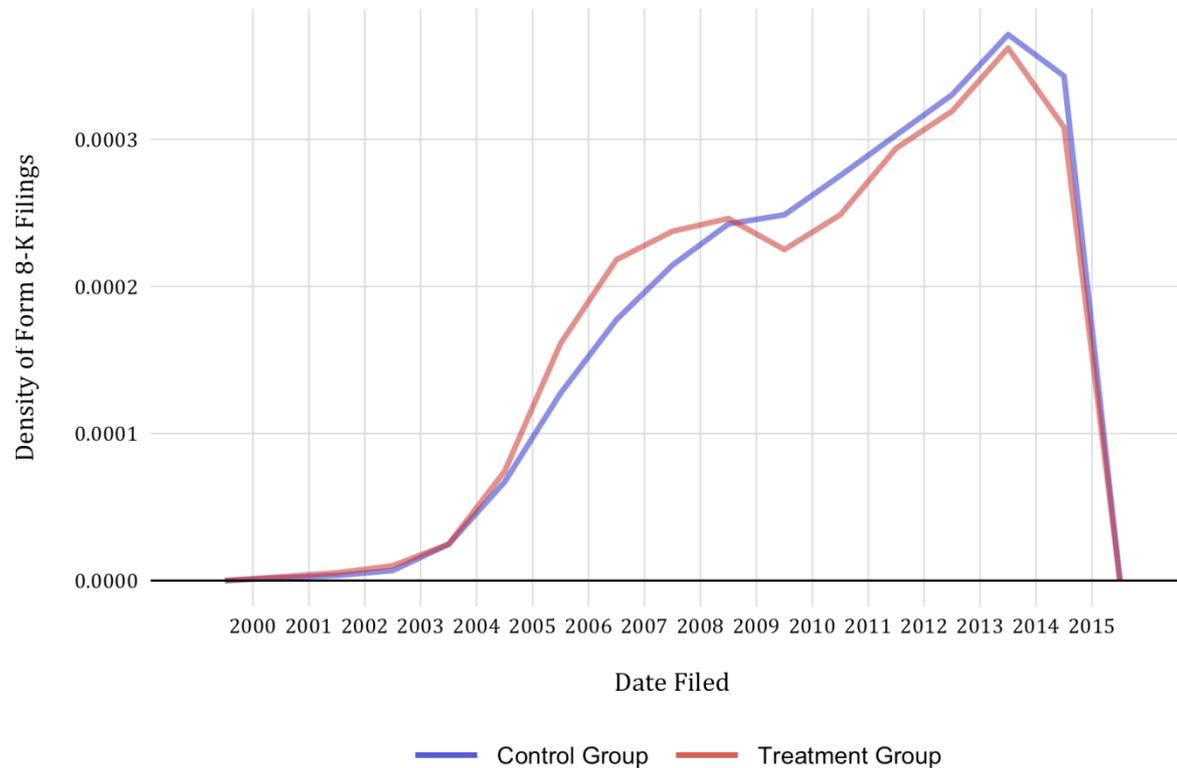
This chart shows that, before the activist gains the keys to the boardroom, target firms have similar leakage as other firms—and then leakage increases quite substantially.



Notably, however, this effect decreases over time, consistent with the predictions of McCrary (2010).

Our Findings: Disclosure Trends

To be sure that our design is valid, we confirm that 8-K filing activity is virtually identical as between our treatment and control groups.



Findings, Continued: Activist Directors

We also provide striking evidence that our leakage finding is driven by activist *employees* appointed to the board, rather than other types of directors (such as industry experts).

	Leakage	Leakage	Leakage	Leakage	Leakage
Hedge Fund Employee Director Dummy	-0.0827***	-0.0622**	-0.0784**	-0.0788**	-0.0736**
	(-2.94)	(-1.99)	(-2.33)	(-2.16)	(-1.97)
Not Hedge Fund Employee Director Dummy	0.0036	0.0046	0.0119	0.0072	0.0107
	(0.08)	(0.11)	(0.25)	(0.15)	(0.22)
Post	-0.0045	-0.0091	-0.0053	-0.0245	-0.0248
	(-0.33)	(-0.63)	(-0.33)	(-1.06)	(-1.04)
Employee Director Dummy x Post	0.1478***	0.1104**	0.1255**	0.1454***	0.1400**
	(3.14)	(2.26)	(2.40)	(2.65)	(2.54)
Not Employee Director Dummy x Post	0.0430	0.0298	0.0315	0.0605	0.0568
	(0.66)	(0.43)	(0.43)	(0.80)	(0.76)
Item FEs	No	No	No	No	Yes
Observations	2,232	1,959	1,610	848	848
R ²	0.006	0.007	0.010	0.025	0.040

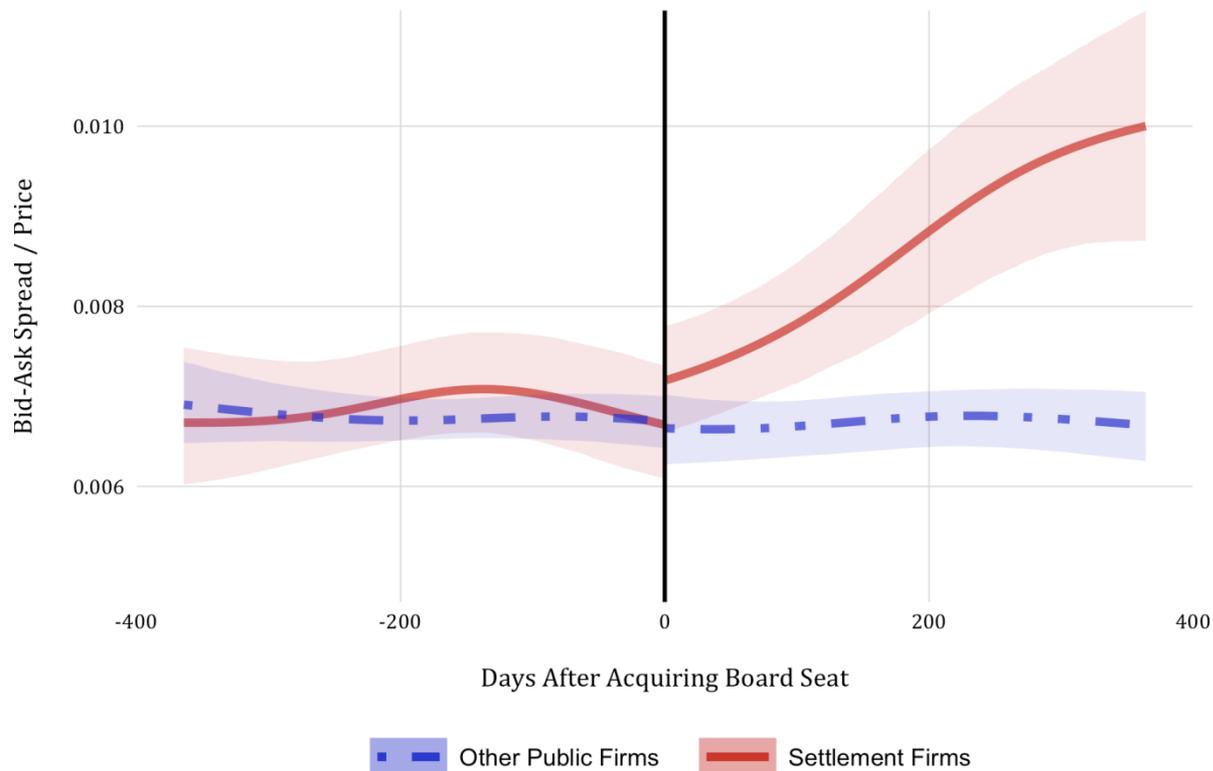
Findings, Continued: Information Agreements

The leakage we observe is driven by settlements with no provisions addressing information sharing among the parties.

	Leakage (no controls)	Leakage (some controls)	Leakage (more controls)	Leakage (all controls)
Information-Sharing Rule (Difference from Control Group)	-0.0096	-0.0665	-0.0771	-0.0878
	(-0.10)	(-0.67)	(-0.77)	(-0.88)
No Information-Sharing Rule (Difference from Control Group)	-0.2138**	-0.2355**	-0.2090**	-0.2232**
	(-2.40)	(-2.37)	(-2.02)	(-2.21)
Post (Difference from Pre)	-0.0059	-0.0121	-0.0236	-0.0226
	(-0.48)	(-0.90)	(-1.61)	(-1.57)
Information-Sharing Rule x Post (Difference in Differences)	0.0047 (0.03)	0.0918 (0.55)	0.0526 (0.33)	0.0453 (0.29)
No Information-Sharing Rule x Post (Difference in Differences)	0.4031*** (2.93)	0.5556*** (3.47)	0.4959*** (3.17)	0.4985*** (3.28)
Market Value of Equity Decile		0.0053** (2.28)	0.0080** (2.23)	0.0090** (2.53)
Idiosyncratic Volatility			0.3728 (1.18)	0.1934 (0.65)
Amihud (2002) Illiquidity			-0.0172 (-1.41)	-0.0153 (-1.28)
Book to Market Value			0.0117** (2.09)	0.0132** (2.40)
Filing Length (In Characters)				-0.0129** (-2.47)
Item FEs	No	No	No	Yes
Observations	31,774	27,462	23,002	23,002

Our Findings: Wider Spreads

As one might predict, market makers respond to these dynamics by widening bid-ask spreads—imposing a cost on all investors, as some transactions cannot occur as a result of these wider spreads.



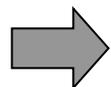
Conclusion

Our paper provides evidence of a significant potential cost of shareholder activism.

- Settlements between activists and boards may raise similar concerns to settlements in the shareholder-litigation context (Romano, 1991).
- The collaboration between shareholders such as activists and corporate boards, and contracting over that collaboration, deserves further theoretical (Fisch, yesterday) and empirical (Bebchuk, Brav, Jiang, and Keusch, 2017) study.
- Firms and lawmakers concerned about these dynamics should consider contractual and legal restrictions on the use of information obtained in connection with activists' appointments to corporate boards.
- To the extent use of this information can be conceptualized as a subsidy of socially valuable activism, boards and regulators should consider giving shareholders the right to ratify such agreements.

Annex A: Findings by Investor Type

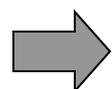
We show that our leakage finding is driven by hedge funds rather than other types of activists.



	Leakage	Leakage	Leakage	Leakage
Hedge Fund Dummy	-0.2099**	-0.2338**	-0.2297**	-0.2442***
	(-2.37)	(-2.40)	(-2.40)	(-2.69)
Not Hedge Fund Dummy	0.0054	0.0187	0.0174	0.0104
	(0.04)	(0.11)	(0.10)	(0.06)
Post	-0.1208***	-0.0855**	-0.0703*	-0.0821**
	(-2.97)	(-1.99)	(-1.65)	(-2.03)
Hedge Fund Dummy x Post	0.2691**	0.2993**	0.2799**	0.2812**
	(2.04)	(2.17)	(2.06)	(2.21)
Not Hedge Fund Dummy x Post	0.1077	0.2926	0.2739	0.2615
Filing Length (In Characters)			-0.0388***	-0.0104
			(-3.00)	(-0.76)
Fog Index			0.0003	0.0007
			(0.18)	(0.42)
# of Times in Factiva Over Prior 10 Days				-0.0001
				(-0.33)
Item FEs	No	No	No	Yes
Observations	4,636	3,333	3,333	3,333
R ²	0.003	0.007	0.011	0.029

Annex B: Changes in Disclosure Behavior

We run these tests to consider whether changes in disclosure *behavior* are driving our results—with some interesting findings.



	# of Factiva Articles, Two Days Prior	# of Factiva Articles, Ten Days Prior	Contains “Press Release”	Length of Filing (Characters)	Fog Index
Treatment	1.2062 (1.03)	7.6201 (1.56)	0.0242 (0.89)	-0.7750 (-1.32)	-0.0237 (-0.24)
Post	0.9967** (1.97)	5.7739*** (2.93)	0.0024 (0.18)	-0.3341 (-1.04)	0.3476*** (7.63)
Treatment x Post	-2.7977** (-2.33)	-8.0963 (-1.40)	-0.0409 (-1.06)	-0.0578 (-0.07)	-0.4393*** (-3.54)
Observations	142,459	98,682	98,681	98,681	142,459
R ²	0.000	0.001	0.005	0.011	0.000

	Form 8-K Items Related to Results of Operations	Form 8-K Items Related to Financial Statements	Form 8-K Items Related to Other Events	Form 8-K Items Related to Entry Into a Material Definitive Agreement	Form 8-K Items Related to Regulation FD Disclosure
Treatment	-0.0684*** (-2.85)	0.0050 (0.21)	0.0255 (0.91)	0.0612*** (2.83)	0.0117 (0.46)
Post	0.0012 (0.09)	-0.0043 (-0.36)	-0.0105 (-0.89)	-0.0053 (-0.57)	0.0276** (2.49)
Treatment x Post	0.0179 (0.53)	-0.0291 (-0.86)	-0.0497 (-1.38)	-0.0268 (-0.91)	-0.0632** (-2.06)
Item FEs	No	No	No	No	Yes
Observations	142,459	98,682	98,681	98,681	142,459
R ²	0.000	0.001	0.005	0.011	0.000