CORPORATE GOVERNANCE

Lecture 3 Shareholders and Shareholder Activism I

Prof. Daniel Sungyeon Kim

TODAY'S AGENDA

- What is Shareholder Activism?
  - Activism by Individual Shareholders
  - Monitoring by Large Shareholders
  - Institutional Shareholders
- Types of Shareholder Activism
  - Shareholder Proposals
  - Proxy Fights
  - Shareholders Lawsuits

1. WHAT IS SHAREHOLDER ACTIVISM?

- Definition
  - The idea that investors should work to influence the running of the companies in which they invest, primarily through the casting of shareholder voting

  - This activity is designed to deter poor governance that might pose a long-term threat to the profitability of the companies that shareholders invest in.

  - This activity received a lot of exposure in 2012, in what became known as the "shareholder spring"

1. WHAT IS SHAREHOLDER ACTIVISM?

- Three kinds of shareholders
  - Individual Shareholders
  - Large Shareholders
  - Institutional Shareholders

1.1. ACTIVISM BY INDIVIDUAL SHAREHOLDERS

- Three kinds of shareholders
  - Modest number of shares
  - Submit proposals to be voted
  - Lewis Gilbert, the owner of 10 shares of New York's Consolidated Gas Company
    - He pushed for reform in 1942 and the SEC created a rule to allow shareholders to submit proposal that could be put to a vote

1.2. MONITORING BY LARGE SHAREHOLDERS

- Is it good for firms to have a large shareholder?

- Case Study
  - "Chrysler Takeover Attempt"

1.2. MONITORING BY LARGE SHAREHOLDERS

- If you were the CEO of Chrysler, would you accept the bid?

- Is $7BN too much as a cushion?

1.2. MONITORING BY LARGE SHAREHOLDERS

- Kirk Kerkorian
  - A notable activist investor
  - A self-made Las Vegas billionaire
    - Acquires Trans International Airlines for $60,000 in 1947. Starts service from Los Angeles to Las Vegas. Sold for $104 million in 1968.
    - Buys 80 acres in Las Vegas in for $960,000 in 1962. Sold to builders of Caesar's Palace for $9 million in 1969.
    - Builds International Hotel (now Las Vegas Hilton) in 1967. Hires Elvis Presley as opening act.
    - Purchases MGM movie studio in 1973; builds MGM Grand casino; sells, re-acquires, re-sells the film business.
    - Subsequent acquisitions in casino industry increase his net worth to $16 billion by 2008, at age 91.

1.2. MONITORING BY LARGE SHAREHOLDERS

- Kirk Kerkorian and Chrysler
  - 1990: Buys 9.8% of stock at $10 / share
  - 1991: Buys more
  - 1992: Company refuses board seat
  - 1994: Company raises dividend
  - 1994: Buys more
  - 1995: Hostile takeover attempt at $55 / share ($20.5 billion

1.2. Monitoring by Large Shareholders

- What did Kerkorian want?
  - Chrysler had accumulated a cash balance of $7B
  - Company said "it needs this to get through the next recession"
  - Kerkorian proposed to pay a dividend to himself of $5.5 billion

1.2. MONITORING BY LARGE SHAREHOLDERS

- Did Chrysler need $7 billion cash?
  - Claimed it would not always have access to capital markets in a credit crunch
  - Kerkorian's counter claim: the cash allowed the company to avoid painful changes
  - Many analysts agree with Kerkorian that Chrysler cash hoard is too big

1.2. MONITORING BY LARGE SHAREHOLDERS

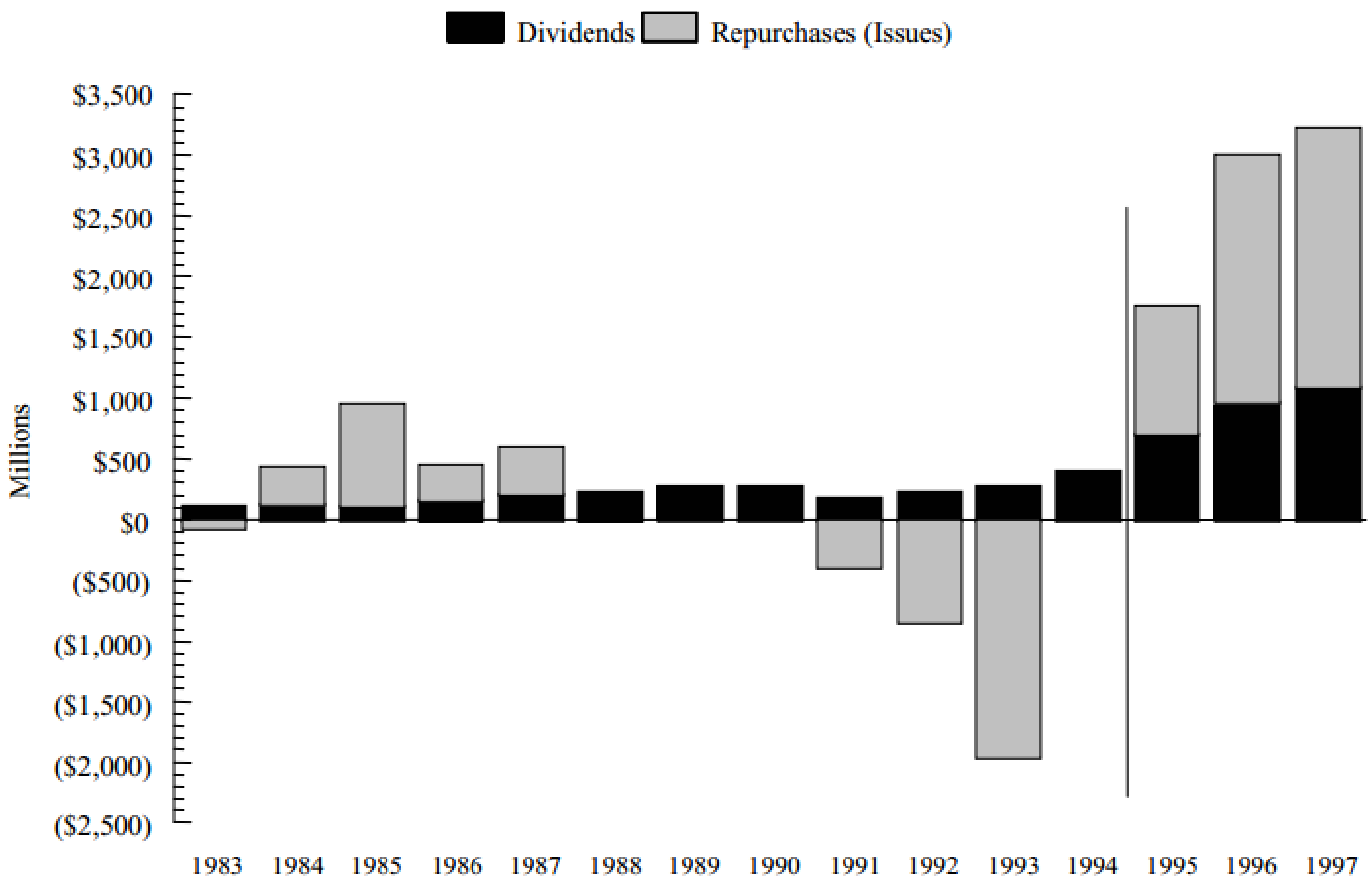
- Did Chrysler need $7 billion cash?

1.2. MONITORING BY LARGE SHAREHOLDERS

- What happened
  - Chrysler increased dividend 60 percent and initiated $1 billion share repurchase
  - However, Kerkorian announced a takeover offer
    - $3 billion his own money
    - $12 billion from investors
    - $5.5 billion of Chrysler's own cash
  - Chrysler rejected the offer.

1.2. MONITORING BY LARGE SHAREHOLDERS

- What happened
  - Large payouts to placate Kerkorian



1.2. MONITORING BY LARGE SHAREHOLDERS

- What happened: Epilogue
  - On May 7th, 1998, it merged with Daimler-Benz with $37 billion stock-swap deal, so called "Merger of Equals"
  - Three years later, Chrysler Group's share value has declined by one-third relative to pre-merger values.
  - Its stock has been banished from the S&P 500.
  - Why the Merger Failed?
    - Culture clash and Mismanagement

1.2. MONITORING BY LARGE SHAREHOLDERS

- What happened: Epilogue
  - Kerkorian
    - 2005: makes major investment in General Motors. Sells in 2006 after failing to merge GM with Renault.
    - 2007: Offers to buy Chrysler from Daimler for $5 billion. Chrysler sold instead to Cerberus for $7.4 bil
    - 2008: Buys 6.5% of Ford, sells at a big loss amid global rout of auto industry
    - His MGM Grand casino holdings melt down from $14.6 billion to $0.5 billion by early 2009, as he prepares to turn 92

1.2. MONITORING BY LARGE SHAREHOLDERS

- Bill Gates and Microsoft
  - Owned 49 percent of Microsoft at its initial public offering in 1986
  - Have a strong vested interest in Microsoft's growth and financial success

- Comparison between manager-owners and plain owners
  - Microsoft has little conflict of interest problems between owners and managers
  - Plain owners exacerbate the conflicts
  - Minority shareholders are clear beneficiaries of large shareholders

1.2. MONITORING BY LARGE SHAREHOLDERS

- Role of Large shareholders
  - Active monitors
  - Market for corporate control
  - However, public firms can be so large that it would take a lot of wealth to own a significant fraction
  - Further, most investors may not wish to forgo the benefits of portfolio diversification

1.3. INSTITUTIONAL SHAREHOLDERS

- Governance by Institutional Investors
  - Pension funds, mutual funds, hedge funds, exchange-traded funds, and other investor groups

2010 US equity holdings	Private Pension funds	State/local Pension funds	Mutual funds	Insurance companies	Household sector
$ billion	1,674	1,453	3,815	1,452	6,768

  - Fiduciary responsibility: Guardians of investors who have entrusted their money
  - Should demand and enforce the shareholder value maximization objective

1.3. INSTITUTIONAL SHAREHOLDERS

- Greater chance of success in proposal
  - Gillan and Starks (JFE 2000): Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors

- Why do they become more active?
  - Dramatic increases with pension funds and mutual funds
  - Fewer than 100 funds to hold about half of the U.S. stock market

1.3. INSTITUTIONAL SHAREHOLDERS

- Conflicts of interest because of business ties
  - Banks, insurance companies, and mutual fund companies frequently derive benefits from lines of business under their portfolio firm's management control

1.3. INSTITUTIONAL SHAREHOLDERS

- Conflicts of interest
  - Fidelity, the largest mutual fund company held blocks of 10% or more in several dozen of the largest 1000 U.S. firms in 2001.
    - It takes an activist public stance on corporate governance issues in Europe.

1.3. INSTITUTIONAL SHAREHOLDERS

- Conflicts of interest
  - But it is in quiescent in the U.S., where it earns substantial fees for managing corporate pension accounts.
  - During the 2003-2004 proxy voting period, it voted only 33% favor of shareholder proposals calling for improved corporate governance. It voted 67% either against or abstained.
  - In 2010, supported shareholder-sponsored governance resolutions only 12%.

1.3. INSTITUTIONAL SHAREHOLDERS

- Conflicts of interest
  - Insurance companies
    - Restrictions on investing their own funds in equities
    - Only 14 % of fund assets are invested in equities
    - Hold debt securities of any companies investing
    - Have a commercial relationship with companies
    - No obligation to report to their customers on their proxy voting

1.3. INSTITUTIONAL SHAREHOLDERS

- Public pension funds are free from such conflicts of interest.
  - CalPERS, the largest pension fund ($300 B) for California's public employees, has been the leading advocate for improved corporate governance.

1.3. INSTITUTIONAL SHAREHOLDERS

- Pension funds
  - They have a fiduciary responsibility to their plan participants and beneficiaries
  - Their size and expertise make their activism effective
  - They have fewer restrictions on ownership compared to mutual funds.
  - Long-term active ownership role
  - Mutual funds have to diversity into at least 20 separate companies or additional taxation.

1.3. INSTITUTIONAL SHAREHOLDERS

- Pension funds
  - Who watches the watchers?
  - What are the qualifications of the trustees?
  - Even CalPERS, which voted 100% in favor of all other governance-related shareholder proposals, abstained from voting on proposals to expense stock options.
    - High-tech business community in California has been the leading opponent of expensing options.

1.3. INSTITUTIONAL SHAREHOLDERS

- Short-term investment strategy
  - Many active investors have a speculative or short-run view of the stock market
  - Limits their desire to be activists

2. TYPES OF SHAREHOLDER ACTIVISM

- Shareholder Proposals
- Proxy Fights
- Shareholders Lawsuits

2.1. SHAREHOLDER PROPOSALS

- US rule: Anyone owning more than $2000 or 1 percent of a firm's stock for at least one year can submit a proposal
- At annual meetings, shareholder proposals will be voted on by all shareholders
- Nominations for the election of directors (proxy fight) are not allowed.
- Example: antitakeover amendments, shareholder voting rules, or board composition

2.1. SHAREHOLDER PROPOSALS

- However, in practice, most shareholder proposals do not pass
  - It is difficult and used to be expensive for one shareholder to communicate with all other shareholders
  - Managers and board can freely spend the company's money in lobbying against the proposal
  - Management controls the votes of the uncommitted shareholders

2.2. PROXY FIGHTS

- Contested Election of Director (Proxy Fights)
  - Shareholders can replace poorly performing directors
  - In hostile takeovers, the management and board are not complacent.
  - In order to affect the takeover, the raider must either:
    - get the target's board to submit the takeover for shareholder approval
    - replace the target's board

2.2. PROXY FIGHTS

- Contested Election of Director (Proxy Fights)
  - In a hostile takeover, the acquirer attempts to convince the target's shareholders to unseat the target's board by using their proxy votes to support the acquirer's candidates for election to the target's board

2.2. PROXY FIGHTS

- Example: Microsoft vs. Yahoo!
  - In the spring of 2008, Microsoft made a $47.5 billion hostile offer to buy Yahoo!.
  - Yahoo! uses poison-pill employee severance package in order to deter Microsoft's takeover attempt.
    - Yahoo! estimated the cost of post-acquisition layoffs as up to $2.1 billion.

2.2. PROXY FIGHTS

- Example: Microsoft vs. Yahoo!
  - Yahoo! Shareholders tried to replace the board that had rejected the Microsoft offer
  - Carl Icahn took the lead in nominating directors to an replace the existing directors
  - Only one director lost his position following a high-profile proxy fight

2.2. PROXY FIGHTS

- Why is it so difficult?
  - The nomination of board members is typically handled by a committee of the current board.
  - There is only one nominee for each seat

2.2. PROXY FIGHTS

- Strategy
  - Shareholders can make suggestions to who to nominate
  - Proxy solicitation
    - Creates a contested election of directors, or a proxy fight
    - Very costly (numerous mailings to all shareholders and file many documents)
    - Again, management controls the votes of the uncommitted shareholders
    - Institutional investors often stick with management due to their reputation concerns (Problem of institutional activism)

2.3. SHAREHOLDERS LAWSUITS

- Derivative lawsuits
  - Special lawsuits brought in the company's name against the executives and/or directors.
  - Shareholders can bring an action on behalf of the company and force the directors and officers to repay money to the corporation
  - Any money paid in a settlement goes to the company

2.3. SHAREHOLDERS LAWSUITS

- Derivative lawsuits
  - Recent research shows that it can be an effective corporate governance mechanism
  - Ferris, Jandik, Lawless and Makhija (JFQA, 2007)
    - Derivative Lawsuits and board changes
    - Decrease of inside directors on the board
    - Decrease of CEO board

2.3. SHAREHOLDERS LAWSUITS

- Direct lawsuits
  - Any amounts are paid under a direct suit, they go into the shareholders' pockets

- Why an individual shareholder bring a lawsuit in spite of high legal fees?