PROXY FIGHTS AS AGENCY DISCIPLINE

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Abstract

This paper investigates how proxy fights function to discipline corporate boards of directors to function as agents of the shareholders. One hundred and ninety six proxy fights are investigated between 1988 and 2009 to examine those factors which determine the most closely associated with winning or losing a proxy fight. Dissidents are found to be most likely to initiate and win a proxy fight when cumulative excess shareholder returns are negative. It is concluded that while declines in shareholder wealth do stimulate proxy fights, a semi-strong efficient market interpretation of financial performance leaves ample room for the successful defense of managerial policies and actions. Proxy fights provide an opportunity for dissidents to challenge these policies and actions often enough for proxy fights to be an effective mechanism for compelling fiduciary behavior by corporate boards.

Keywords: Agency Principline, Proxy Fights

1. INTRODUCTION

Proxy fights among US based corporations have been increasing in recent years. Figure 1 presents the distribution of proxy contests between 1988 and 2009, and shows the time-series means of proxy contests, dissident-won contests, and management-won contests. As can be seen both the total number of contests and those won and lost have risen dramatically since 2004. While some of this rise may reflect the trauma of the 2006-2008 financial crisis, this trend has continued unabated through 2015 (Hoffmann, 2016). .

Proxy fights or the threat of a proxy fight arise as an unfriendly action over organization policies or control. These events are generated by dissident stockholders or corporate raiders who sense a profitable opportunity. In a proxy fight, the dissident shareholders attempt to persuade other shareholders to use their proxy votes to wrest control away from the existing Board of Directors or to have the Board change its policies or actions. When shareholders elect a director to the board, they become the shareholder's agent and have the responsibility of acting in the shareholder's best interests.

As the purpose of the corporation is widely construed to maximize the shareholder wealth of the common stockholders and the responsibility of the Board is to act in the best interests of the shareholders, a proxy fight represents a misalignment between the company's board and its shareholders. The corporate form of organization has proved exceptionally adaptive and responsive to contextual changes over time. This durability exists in part to devices such as proxy contests that limit the potential incentive problems created by the separation of ownership and control. For example, Alchian and Demsetz (1972, P788) state that "…the transfer of proxies enhances the probability of decisive action in the event current stockholders or any outsider believes that management is not doing a good job with the corporation."

The effectiveness of the proxy as a disciplinary mechanism for aligning board and shareholder interests may be questioned by the fact that so few proxy contests actually occur. DeAngelo (1988) reports on only 86 proxy contests over 16 years and Faleye (2004) lists only 98 contests over a 13-year period. We confirm the low level of actual proxy fights by observing only 169 proxy fights between 1998 and 2009 from a universe of 22,010 board meetings. An appropriate response to this concern is that the threat of a proxy fight is often sufficient to induce desired changes in board policy and behavior. Fos (2015) and Brav and Jiang (2008) have shown that in anticipation of proxy contests, managers make significant adjustments in favor of shareholders on a wide array of corporate policies.

Questions abound in equities markets as to whether or not boards in fact act in the best interests of their shareholders (Subramanian, 2015). Such question may arise as a result of differences in short or long-run perspectives, differences in risk tolerances, and issues of power and control (Tihanyi, et. al., 2015). The existence of such differences can result in a challenge to Board authority in the form of a proxy contest (Posner, 2014).

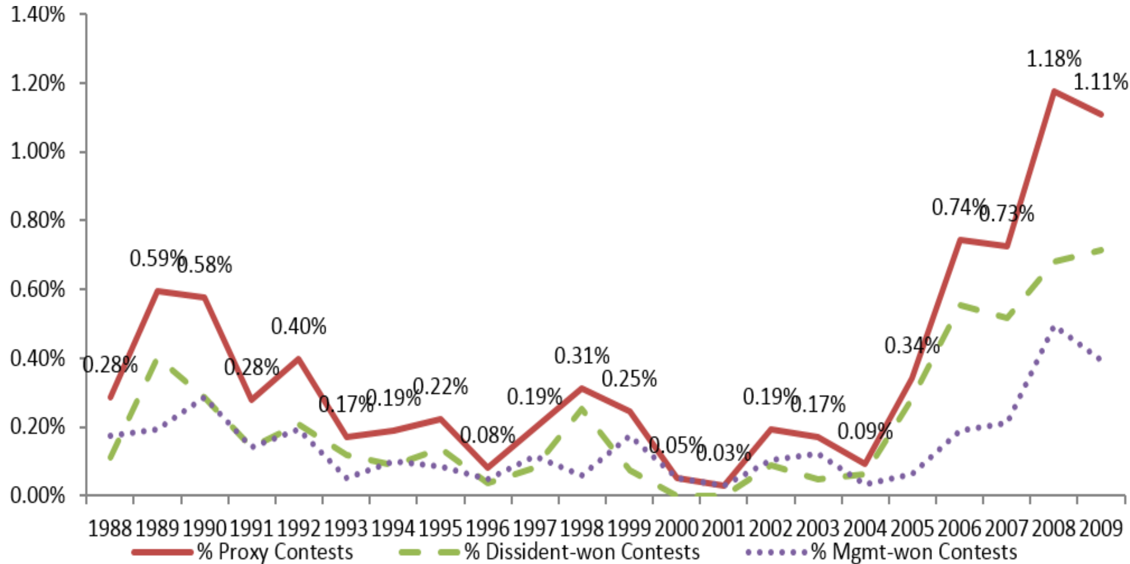
Proxy fights are relatively rare and often unsuccessful. Incumbent directors almost always have the odds in their favor over those trying to force corporate change. Aside from corporate by-laws favoring the incumbents, boards often forestall the proxy fight by modifying its policies to mitigate stockholder dissent or aggressively lobby its shareholders to justify its actions. Proxy fights are nevertheless an important mechanism for aligning board policies with shareholder's interests. Proxy fights or the threat of a proxy fight can, and do, significantly affect board policy and control. In the past, most proxy fights that actually take place have been unsuccessful, in spite that proxy fights waged by well-organized hedge funds or corporate raiders

are often successful despite the odds against them (Klein and Zur, 2009).

This paper examines the distribution of management-won and dissident-won proxy fights in the United States between 1988 and 2009 and compares the relevant characteristics of the firms who won or lost their proxy fights. The purpose of this examination is to shed light on the differences between corporations that have won their proxy fights and those who have lost them.

Figure 1 presents the trend in total proxy fights, proxy fights won and proxy fights lost over our sample period. The frequency of proxy contests increases from 0.28% at the beginning of the sample period to 1.11% in 2009. It can be seen that the frequency of dissident-won contests grows substantially more than that of management-won contests after 2004. These findings are consistent with the widespread adoption of anti-takeover provisions, the enactment of state-level antitakeover laws in 1990s, and the proxy reform in 1992 that made proxy contests more favorable than hostile takeovers.

Figure 1. Time Distribution of % Proxy Contests, % Dissident-won Contests, and % Mgmt-won Contests as a Percentage of the Compustat Universe



2. U.S. PROXY FIGHTS

Shareholder dissatisfaction with Board policy that leads to a proxy fight has historically been thought to reflect poor performance in conventional financial metrics such as debt ratios, dividend payout, return on assets, etc. (Hancock and Mougoue, 1991; Sherman and Krusekopf, 1988). Current thinking on this issue recognizes the ambiguity inherent in financial performance metrics and the need to assess the subtlety and complexity of board policies and control (McGurn, 2014; Posner, 2014; Yen and Ching-Lung, 2005). The use of financial metrics to assess strategic decisions may produce misleading results (Banker, et. al., 2014). Recent proxy threats and proxy fights have ranged over topics as diverse as social activism, environmental concerns, terrorism, and globalization.

The major issue in detecting the existence of an agency problem with the board of directors is the ambiguity inherent in comparing short-run financial performance with long-run shareholder wealth. Judgements about the propriety of board policies and actions are highly subjective as they are contrasted with long-run goals and objectives. Shareholders may well be concerned about current performance even though boards are, in fact, acting in the best interests of the shareholders. The following recent proxy fights are suggestive of the difficulties of reconciling the agency function of a corporate board with their actions.

Harvest Capital Strategies, an investment firm, launched a proxy fight to replace the three members of the Board of directors in Green Dot Corporation, a pioneer in the prepaid credit card industry. Harvest has a 7.2% stake in Green Dot and seeks to replace its founding CEO because of poor financial results and strategic mistakes in product development (Passy, 2016). Shares in Green Dot (GDOT) have fallen from $45 to $22 over the past five years.

GM narrowly avoided a proxy fight over its $25 billion cash hoard and focus on long-term growth. Harry Wilson, the Federal Government's agent for monitoring GM led a coalition of hedge funds to seek a seat on the Board to prompt GM to be more responsive to shareholder concerns. The proxy fight was averted when GM agreed to a $5 billion stock buyback and to increase dividends $5 billion in 2016 (Muller, 2015). In addition, CEO Mary Barra acknowledged a need to trim its long-term strategy to permit greater returns to shareholders.

Sandell Asset Management Company which owns 5.5% of furniture manufacturer Ethan Allen has launched a proxy fight against management's Board of Directors seeking six new members for the Board (Thomas, 2015). At issue is concentration of firm assets in real estate, an autocratic management style, and a poorly performing stock (from $31 to $23 in the past year) The rejoinder by management was that long-term earnings growth was more important than short-term financial performance. The stock recovered its earlier highs in early 2016 following a resurgence of the domestic housing market.

Lion Point Capital which owns less than 1% of the outstanding shares of Ally Capital is engaging in

a proxy fight to gain two board seats for the purpose of exploring a sale of Ally Capital (Peters, 2016). The reason Lion Point is seeking to explore strategic alternatives for Ally is a decline in stock price related to Ally's loss of its lease business for GM cars. Ally's management is resisting this move because it thinks it can improve its financial performance by rolling out new loan products and cross-selling its existing products. As a result of this challenge, Ally is considering a significant stock buyback in 2016.

Corporate raider Nelson Peltz is using his hedge fund (Trian Partners) and it's $1.9 billion stake in DuPont Corporation to generate a proxy fight for control of DuPont with the intention of breaking up the existing corporate structure (Gandel, 2015). Peltz's concern is that the company's share price does not reflect the actual value of its component business and that management is unresponsive to shareholder concerns. DuPont's Board has strongly resisted this attempt on the basis that its long-run value is not currently recognized in its share price. DuPont won the proxy fight, but is currently in the process of re-structuring the Company.

Hedge fund Starboard Value is threatening a proxy fight aimed at replacing Yahoo Chief Executive Marissa Mayer (Parikshit, 2015). The impetus for the challenge is a relative fall in shareholder wealth at Yahoo. Starboard, along with allied hedge funds, seek to have Yahoo divest its Asian assets, including stakes in Chinese e-commerce company Alibaba and Yahoo Japan Corp, and conduct an immediate public auction its search and advertising businesses. Yahoo's Board has resisted these changes arguing the long-term value of the consolidated businesses.

The consistent theme expressed in examples or recent proxy fights or threatened proxy fights is shareholder dissatisfaction as expressed in the market price of their stock. The traditional measures of financial performance *per se* do not appear to matter as much as the assessment of the market of their financial performance. This perspective suggests a semi-strong version of the Efficient Market Hypothesis, where boards possess information about the organization not accessible by the market. Management may argue that short-term financial metrics are not sufficient to capture the longer term potential of the organization or that the challenges to their policies entail unacceptable risks for the proffered return.

3. UNIVARIATE FINDINGS

Our initial contest sample consists of all proxy contests listed in Thomson Financial's Proxy Contest database between 1988 and 2009. We exclude withdrawn deals in the main analysis since there is mixed evidence as to whether such an outcome favors dissidents.[16] We use the Compustat universe merged with the proxy contest dataset, and require that the sample firms also have data on CRSP, and Thomson Financial's 13F databases to collect information concerning earnings and stock market performance, and institutional ownership, respectively. All continuous variables are winsorized at 1% and 99%, and assets are expressed in 2003 dollars. Having matched with all the datasets and missing observations removed, our final sample includes 22,179 firm-year observations with 169 realized proxy contests between 1988 and 2009. The data in Table 1 is based on 169 proxy contests which is comparable to the sample size used in other studies of proxy fights (i.e., 95 contests in Ikenberry and Lakonishok (1993) and 270 in Mulherin and Poulsen (1998)).

This table presents summary statistics for proxy contest variables, firm policy variables, and firm/stock characteristics. All continuous variables are winsorized at the 1% and 99% and assets are expressed in 2003 dollars.

Table 1 shows the clear majority of actual proxy contests during our sample period are won by the current board of directors. Anecdotally, most threats of a proxy contest do not appear to materialize. However, in either situation Board policy is significantly altered by the process of winning the proxy contest or countering the possibility of a proxy fight (Fos, 2015).

The breakdown of the factors associated with winning or losing a proxy fight in Table 1 are revealing of the causes of shareholder dissatisfaction sufficient to mount a proxy fight. Although there is a significant difference between the dividend payout ratios where the proxy contest is won or lost, both payout ratios are low in absolute value. Even though the mean value of the payout ratio is higher in proxy contests won by dissidents than in contests won by the Board, this finding suggests that low payout ratios can generate a proxy fight, but that management may effectively argue that this is the best policy for increasing shareholder wealth.

Debt ratios do not appear to be an issue of contention in determining the outcome of proxy contests. No significant differences are found in the debt ratios of firms winning and losing proxy fights. Although bondholders may be distressed by higher debt levels, shareholders appear to remain focused on equity returns. Insofar as high financial leverage does not raise the specter of bankruptcy, shareholders appear willing to let Board policy prevail in this area.

Table 1 does indicate a significance difference between firms winning and losing proxy fights by the acquisition intensity. Our hand-collected SEC filings suggest that around 50% of proxy contests in our sample are directly or indirectly related to ownership control in firms – merger and acquisition events.

[16] For example, after the Electro Scientific Industries, Inc.'s approval of repurchase plan on Aprial 10, 2007, the dissidents, The D3 Family Fund announced that "we are pleased with ESIO's announcement on April 10 that it booked strong orders in its third fiscal quarter and that its board approved a $50 million share repurchase program. We expressed our enthusiasm for these developments during the company's conference call." Another well-known example of a withdrawn contest is Oracle versus Peoplesoft. The Department of Justice decided to block the deal as anti-competitive. In light of this litigation, Oracle withdrew their candidates. The OsteoTech case is clearly a dissident-won contest since the dissidents achieved the goal of selling the firm and enhancing the shareholder value, while the Oracle versus Peoplesoft contest is not deemed to be value-enhancing. As a robustness check, we also manually checked the demand of withdrawn dissidents, the response from managers, and the reason for withdrawing by checking Edgar filings (such as DEFA13A) and news report (such as Bloomberg.com) to classify the withdrawn deals into management-won vs. dissident-won contests. About 33% of withdrawn deals with clear resolution can be clarified as management victory, and the rest can be considered as dissident victory. Our results remain quantitatively similar after incorporating the withdrawn deals.

Table 1. Proxy Contests in US Markets, 1988-2009

	Won by	
	Board	***Dissidents***
Total	56	113
Percent	67%	33%
Dividends*	0.75%	0.94%
Debt	23.71%	27.83%
Acquisition Intensity*	0.89%	1.42%
Industry Contest Intensity*	1.29%	1.54%
Market/Book Value$_{t-1}$	1.42	1.43
Return on Assets$_{t-1}$*	0.84%	-0.38%
Sales Growth*	-1.01%	1.24%
Excess Cumulative Return$_{t-1}$*	-6.70%	-17.41%
Institutional Ownership*	61.96%	72.61%
* Significant difference in means at p=.01		
Dividends - Common stock dividends to earnings (less extraordinary items)		
Debt - Interest bearing debt to assets		
Acquisition Intensity - Acquisition expenditures to assets		
Industry Contest Intensity - Incidence of industry proxy contests		
Market/Book Value$_{t-1}$ - Market value of assets to book value of assets		
Return on Assets$_{t-1}$ - Operating income before depreciation to assets		
Sales Growth - Annual change in sales		
Excess Cumulative Return - Annual corporate return less market return		
Institutional Ownership - Percent of outstanding shares owned by institutions		
Data sources: Thomson Financial proxy Database, Compustat, CRSP.		

Also Table 1 does not suggest a significant difference in means between winning and losing firms in the ratio of market to book value. This reflects the fact that investors are not interested in this theoretical relationship, but rather in absolute shareholder value. This can be seen by the large and significant difference in excess cumulative returns between firms that win proxy fights and firms that lose proxy fights. Where this ratio is negative, there is a clear tendency for proxy contests to occur. Management appears able to win those contests where those negative returns are not particularly large. This may reflect the fact that management is able to make the case for the difference between short-run and long-run performance. However, when the loss of shareholder value is much larger, shareholders are less likely to buy into management's explanations of declining shareholder wealth.

The firm's performance in return on assets is also found to affect the relative success of management and dissidents in a proxy contest. A very low ROA does not preclude management being able to explain away its financial performance and win the contest. However a negative ROA challenges management's credibility in justifying its strategies and increases the probability of success in the proxy challenge.

Sales growth would be expected to be a key driver of organizational success. Unexpectedly, negative sales growth by the company is associated with proxy contests won by the Board. In contrast, where sales growth is positive, but low, dissidents are more likely to win a proxy challenge. This may reflect the fact that negative sales growth will force management to have a plan to address this situation, even without a proxy fight. The fact that management has already addressed this issue and developed a seemingly viable plan to restore sales growth may help it win a proxy fight. However, low sales growth by itself may not force management's attention to this problem. Where sales growth is low and management is perceived as complacent or inattentive to this problem, a successful proxy fight by dissident shareholders is more likely.

Table 1 further suggests the degree of institutional ownership may also have an impact on proxy contest outcomes. Corporations with greater institutional ownership are more likely to have dissidents mount a successful proxy fight. The impact of larger institutional ownership may reflect a greater ease of collecting a sufficient number of proxies to win a contest, as opposed to a situation where corporate shareholders are more diverse.

4. CONCLUSION

Mounting a proxy challenge to board membership or policies is a difficult, and therefore infrequent, task. The motivation for such a challenge must be strong enough to overcome the numerous obstacles a board is likely to place in the way of a dissident initiative. The board of directors should serve as the agent of the stockholders in furthering their interests. Where a significant number of shareholders feel that this is not the case, they may agitate for a proxy contest. However, the board usually resents this challenge to its power and authority and responds to such criticism with a justification of its strategies and/or policies The logic behind such explanations often lie in the difference between the short-run and long-run interpretation of events, or in the perception of different risk-return tradeoffs. Such explanations often defy objective criteria and become matters of perception and subjective judgement.

This paper has explored those factors that make it more or less likely for a proxy contest to succeed or fail. The above analysis suggests that the likelihood of a successful proxy challenge is related to a shareholder focus on their financial returns. These financial returns can be measured by dividends and excess cumulative returns in the market. The success or failure of a proxy fight can also be influenced by the context of that fight. Particularly important here are the prevalence of other proxy fights in the same industry and the degree of institutional ownership.

Whether or not boards of directors are effective agents for shareholder is often ambiguous. The findings above suggest that where the financial performance of the organization is particularly egregious, shareholders are able to penetrate that ambiguity and successfully challenge the board through a proxy fight. Thus, the proxy system remains an effective discipline mechanism to ensure that boards of directors act in the best interests the organization's stockholders.

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