March 8, 2013

Important Questions About Activist Hedge Funds

In what can only be considered a form of extortion, activist hedge funds are preying on American corporations to create short-term increases in the market price of their stock at the expense of long-term value. Prominent academics are serving the narrow interests of activist hedge funds by arguing that the activists perform an important service by uncovering "undervalued" or "under-managed" corporations and marshaling the voting power of institutional investors to force sale, liquidation or restructuring transactions to gain a pop in the price of their stock. The activist hedge fund leads the attack, and most institutional investors make little or no effort to determine long-term value (and how much of it is being destroyed). Nor do the activist hedge funds and institutional investors (much less, their academic cheerleaders) make any effort to take into account the consequences to employees and communities of the corporations that are attacked. Nor do they pay any attention to the impact of the short-termism that their raids impose and enforce on all corporations, and the concomitant adverse impact on capital investment, research and development, innovation and the economy and society as a whole.

The consequences of radical stockholder-centric governance and short-termism prompt a series of questions that cry out for re-examination of basic premises by the academics who exalt simplistic principal/agent theories and neo-classical economic models on only select principal/agent relationships while ignoring not only all social cost and all of behavioral economics but even the application of these same agency theories to other key actors in the current financial landscape. So too do they cry out for re-examination of the regulations that facilitate corporate raiding and short-termism and the failure to put in place a system that would allow managements to achieve the optimal long-term value of public corporations, for the benefit of long-term investors and the whole American economy. The boot-strap, bust-up, junk-bond takeovers of the 70's and early 80's proceeded unchecked and laid waste to the future of many great companies, all cheered on by the academics and aided by do-nothing regulators. The new incarnation of sacrificing the future for a quick buck is at least as dangerous. It requires new thinking to address the new threat.

Among the questions that must be addressed are:

1. **Purpose of the American Business Corporation**. Is the fundamental purpose of the American business corporation, and the proper goal of sound corporate governance, optimal long-term value creation? Or is the purpose to maximize short-term stockholder value at any time any particular stockholder—with its own goals and agenda, which are unlikely to be congruent with the interests of other stockholders—happens to demand it?

2. **How Are "Excess" Returns Actually Obtained**? Activist hedge funds are reportedly outperforming many other asset classes as their raids seem to "unlock" value through pressured transactions. Is this value actually created, or merely appropriated from fellow stockholders with longer-term investment horizons, and from other stakeholders such as employees, including by sacrificing capital spending and investment in long-term research and development?

3. **Are There Really Best Practices**? Is there sufficient (or any genuine) evidence that "best practices" corporate governance of the type promoted by the academics and advisory services results in enhanced long-term performance of the corporation — especially given the fact that American corporations have historically enjoyed the best long-run performance in the world? Is "best practices" corporate governance a major factor in short-termism?

4. **Structural Conflict**. Is there a structural conflict in a system in which stockholders exercising power over a corporation owe no legal duty to anyone and are an ever-changing group that is free to enter a stock in size without advance disclosure and exit at any time of their choosing, act in concert, or even mask their interests using derivatives and engage in empty voting? And in which the decision-makers at these stockholder bodies are themselves agents, compensated, in many cases, on the basis of the short-term performance of the investment portfolios they supervise on behalf of savers and investors?

5. **The "Principal/Agent" Premise**. Is the essential premise of the stockholder-centric proponents – the principal-owner/agent view of the corporate firm – accurate or reasonable, given that the legal system gives legal immunity to the "owners" (stockholders) and imposes fiduciary duties and liabilities on the "agents" (directors)?

6. **The Missing Principal**. Is the principal/agent structure of institutional investors imposing an unacceptable cost on corporations when the underlying beneficial holders of the managed portfolios– retirees, long-term investors and savers – play little if any role in checking the power of those running the investment intermediaries? Regulation, litigation, and public scrutiny perform powerful roles in addressing agency costs that may exist at the corporate board and management level. But given the massive intermediated ownership of public corporations today by a variety of different types of institutional investors with varied compensation and governance arrangements of their own, do we fully understand the agency costs of these investment intermediaries, who is bearing those costs and whether they are being sufficiently monitored and mitigated? And why has the academy not fixed its gaze on these powerful actors, including advisors such as ISS and Glass Lewis?

7. **Trust the Directors**. Is the assumption by academics that directors on corporate boards cannot be trusted based on any actual evidence, on observed anecdotal information, or just the skepticism of a group that has never (or rarely) been in the boardroom or been charged with overseeing a for-profit enterprise? And does the constant assumption and allegation of untrustworthiness in fact create both a disincentive to serve and a disinclination to act, all to the detriment of the corporate enterprise and its beneficiaries?

8. **Directors' and CEOs' Time**. Is it desirable that directors and CEOs spend a third of their time on governance? Has the governance-rather-than-performance-centric debate resulted in a new breed of lawyer-type-CEOs and box-checking "monitoring" boards rather than sophisticated and experienced "advising" boards?

9. **Escaping Governance**. What part of the private equity activity wave is fairly attributable to increased costs imposed by corporate governance in the public markets that makes management for long-term value appreciation difficult or impossible in those public markets? Is that good or bad?

10. **Why Do Venture Capitalists and Entrepreneurs NOT Choose the Academics' Governance Model**? Why do highly successful technology corporations go public with capital structures that preserve management control? To avoid the pressure for short-term performance? To avoid shareholder pressure on management? Do these companies underperform or are they our most innovative companies?

11. **Economic and Business Theory.** Is there any evidence that the ideas and suggestions of short-term money managers, who oversee diverse portfolios, promote long-term (or even medium-term) value creation? What happens to investment, strategic thinking and risk management in a world in which the ideas have time horizons measured in months or quarters? How do the advocates of stockholder-centric governance take account of the fact that stockholders do not have information and expertise about the corporation on a par with its directors and officers? Similarly are long-term stockholder interests and wealth creation served by intermediaries in the proxy advisory services, operating without regulation or fiduciary duty, either to the corporation or its stockholders or to investors and beneficiaries? And what to make of the elephant-in-the-room fact that activist hedge funds don't have to eat what they cook?

12. **Political Theory**. At bottom, doesn't the stockholder-centric theory hark back to the crudest 19th century aspects of laissez-faire capitalism—pressing for the legal system to recognize a single social good (maximizing rentiers' portfolio returns) while ignoring or slighting the interests of employees, communities and societal welfare? Is stockholder-centric governance as currently promoted and practiced by the academic and governance communities, and the short-termism it imposes, responsible for a very significant part of American unemployment and a failure to achieve a GDP growth rate sufficient to pay for reasonable entitlements without a significant increase in taxes?

Martin Lipton
Theodore N. Mirvis
Adam O. Emmerich
David C. Karp
Mark Gordon
Sabastian V. Niles