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Anticipating loss from proxy contests[☆]

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ABSTRACT

In this paper, we examine corporate policy decisions made in anticipation of and subsequent to a proxy contest. Our results suggest that managers increase dividend payouts and leverage and decrease acquisition spending in the year prior to the proxy contest when they anticipate that dissidents may prevail in the contest. Furthermore, these policy concessions to dissidents are not reversed in the year after the proxy contest. On the other hand, managers do not change corporate policies prior to the contest when they expect to prevail over dissidents. Furthermore, they take advantage of winning the contest to pursue policies that reduce the extent of discipline imposed on them. Overall, our results suggest that proxy contests play a disciplinary role only when incumbents anticipate a loss in the contest and are therefore forced to pursue policy choices preferred by dissidents.

"Public company boards are scared to death of activists and will do all kinds of things to avoid proxy contests."

- May 17, 2016, Fortune Magazine.

1. Introduction

The theory of industrial organization suggests that the threat of potential competition affects incumbents' strategic choices in firm outputs made to maintain market power (e.g., Tirole, 1988). Empirical studies find strong evidence of entry deterrence practices implemented by incumbents in several industries. Some of these practices result in "unappealing" equilibria with empty threats (Masson & Shaanan, 1986; Smiley, 1988). Furthermore, the concept of perfect equilibrium, developed by Selten (1975), requires that any such strategy chosen by players within an industry be a Nash equilibrium not only for the entire game but also for every sub-game, ruling out all equilibria that contain non-credible threats.

A game theoretical approach provides a useful framework to study the economic implications of relationships between intra-firm players. Indeed, the nexus of contractual relationships within a firm can be viewed as a long-term outcome of an equilibrium stemming from a repeated game between resource holders with different incentives and interests (Jensen & Meckling, 1976). Where differences in incentives and interests are resolved internally by the board, the resultant policies may be challenged externally by activists who dispute the board's interpretation of what is in the interests of stockholders. Such issues appear more likely when the board is insular, intransigent, or entrenched (Mathur, Singh, Thompson, & Nejadmalayeri, 2013; Posner, 2014). Should activist shareholders, institutions, or hedge funds determine that an agency problem exists, they may attempt to initiate a proxy contest to address specific issues or to seek control of the board. The strategic interplay between dissident shareholders and management prior to, during, and subsequent to a proxy contest can be evaluated within a game theoretic framework. Both dissidents, as well as incumbent management, hope to achieve their respective objectives without having to engage in an expensive and distractive proxy fight. Consequently, each party acts strategically prior to a proxy contest in an effort to force concessions from the other. For instance, Brav, Jiang, Partnoy, and Thomas (2008) and Klein and Zur (2009) find that activist hedge funds often strategically use the threat of a proxy fight to seek policy concessions from incumbent management. Similarly, incumbents on the other hand, in an attempt to avoid an escalation of conflict with dissidents that could lead to a proxy contest, seek to identify and then strategically manipulate policy

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choice variables that are most likely to be effective in undermining the dissidents' position. The incumbent's strategic dilemma is best captured by a recent article in *The Economist* (May 13, 2017), which recommends that CEOs "*make concessions if you have to*" as a last resort to avoid conflict instigated by dissident shareholders. In line with the above-described strategic interplay, Fos (2017) finds that, in anticipation of a proxy contest, managers make significant concessions to shareholders on a wide array of corporate policy choices including R & D expenditures, capital expenditures, leverage, dividends, and managerial compensation. Overall, recent research on proxy contests has provided the following valuable insights: a) the threat of a proxy contest is sufficient to obtain policy concessions from incumbents, b) incumbents offer policy concessions in an attempt to reduce the probability of a contest, and c) proxy contests can play an important disciplinary role in aligning the interests of management with that of shareholders and thereby increase shareholder value (Brav et al., 2008; Fos, 2017; Klein & Zur, 2009).

The effectiveness of proxy contests as an instrument to alleviate agency conflicts, however, is not universally accepted. An alternative view in the literature suggests that a proxy contest alone may not fully ensure that managerial policy choices enhance shareholder value. For instance, Pound (1988) finds that system-wide problems in proxy solicitations reduce the effectiveness of proxy contests as a means to challenge management and gain corporate control. Furthermore, not all proxy threats lead to management concessions; indeed, even when they do, not all concessions and policy changes are sizably significant or long-lasting. In addition, the performance of targeted firms, following proxy contests, are often disappointing. For instance, Ikenberry and Lakonishok (1993) find that operating performance typically declines and cash dividends do not show dramatic improvements subsequent to a proxy contest. Similarly, Klein and Zur (2009) find no improvement in operating performance in the years before and after the initiation of a proxy threat. Likewise, Bebchuk (2007) argues that "*the power of shareholders to replace the board is a central element in the accepted theory of the modern public corporation with dispersed ownership. This power, however, is largely a myth.*" Overall, the above studies cast doubt on the view that proxy contests serve as an effective disciplinary mechanism to enhance shareholder value.

In this paper, we attempt to reconcile these two divergent perspectives on the effectiveness of proxy contests as a governance mechanism. The contrasting views on the efficacy of proxy contests in the literature have likely arisen because several relevant questions that are central to assessing the effectiveness of proxy contests as governance mechanisms remain unaddressed. For instance, since management strategically determine whether and when to make policy concessions to placate shareholders, it is not clear as to whether policy changes made under the threat of a proxy contest are transient and likely to be reversed once the threat of a contest dissipates or instead represent a long-term shift in the strategic orientation of the firm. While the former situation calls into question the effectiveness of proxy contests, the latter is a testament to its role in alleviating agency conflicts. It is also not clear from existing literature as to whether policy concessions offered by management is predicated on the extent of credibility of the proxy threat. Extending the focus of research beyond policy decisions made prior to a proxy contest, to additionally examine corporate policies subsequent to an actual proxy contest allows us to address some of the above-described gaps in the literature as well as to provide additional insights on the economic effects of proxy contests.

Therefore, our primary research focus is to investigate whether the disciplinary effects of proxy contests are contingent on the extent of credibility of the proxy threat. We argue that rather than the threat of a proxy contest, it is the likelihood of losing the contest that has the most significant effect in shaping managerial behavior. Specifically, consistent with the implications of the game theoretical framework (e.g., Tirole, 1988), managers are less likely to take proxy threats into account while making corporate policy choices when the threat of losing a proxy contest is low. This could be the case when the firm's current performance is good (Cai, Garner, & Walkling, 2009) and/or there are no well-organized block of shareholders, such as influential hedge funds or former insiders, who have the resources and capabilities to mount a credible proxy contest that can succeed (Kahan & Rock, 2010).[1] Conversely, when managers expect dissidents to prevail in the proxy contest, career concerns related to reputational loss, job security, and potential change of control that may follow a loss make it more likely that they will comply with dissidents' demands in an attempt to prevent a contest from occurring or alternatively at least diminish the chances of dissidents winning the contest should one materialize.[2]

As a second thread of inquiry, we investigate whether policy changes made in anticipation of a contest are maintained or reversed when the threat of a proxy contest is no longer present. We consider whether proxy contests, as an enforcement mechanism, can result in a non-Nash equilibrium where managers have an incentive to deviate from choices within preexisting corporate policies. This research question is motivated by the fact that a short-term disequilibrium arising from exogenous and/or endogenous changes may lead to temporary power differentials between managers and stakeholders. If adjustments in corporate policies by incumbent management prior to the contest are due to a temporary power shift in favor of dissident shareholders, pursuant to its withdrawal or materialization, prevailing incumbents can reverse the prior changes in policies in parallel to a reverse power shift from dissident shareholders back to managers. In such a situation, the disciplinary role of proxy contests is likely to be transient.

As argued earlier, the above predictions, motivated by the game theoretical perspective, have not yet been tested by prior work on proxy contests. We, therefore, evaluate our above-described predictions by collecting a sample of proxy contests that occurred between 1988 and 2009. Collecting data from several sources, we ensure that our empirical specifications control for firm investment and accounting performance, institutional ownership, and corporate governance structure. In addition, we consider the potential for selection bias by using Heckman's (1979) correction and the interdependency of corporate policy decisions by implementing a system of simultaneous equations (three-stage least squares estimates, or 3SLS). Finally, we evaluate policy decisions in the period before and during the announcement of a proxy contest as well as in the year after the completion of the contest.

From the perspective of management, the credibility of a proxy threat largely rests on uncertainties related to two factors, i.e., the ability of dissidents to follow through on their threat of a proxy contest as well as their likelihood of prevailing in the contest (support from other influential shareholders). From the initial communication of dissident dissatisfaction with the strategic direction of the company to the threat of a proxy contest and finally escalation resulting in the announcement of a contest, management increasingly seek and receive market information that allows them to refine and update its assessment of the above described underlying factors that determine

[1] Butz (1994) argues that a larger concentration of shares increases the credibility of threats and makes it more likely that management will pursue shareholders' interests. In addition to a significant block of shares, Butz (1994) lists takeover threats, splitting the title of CEO and Chairman, promoting potential successors to current management, and accelerating timetables for succession as examples of other types of potential threats to deter management from exploiting its utility at the expense of stakeholders.

[2] As an illustration of the notion that the prospect of losing a proxy contest may be as important as, if not more important than, the threat of a proxy contest itself, consider the situation faced by Lawndale Capital Management LLC and P & F Industries, Inc. (PFIN) in 2010. The incumbent management of P & F Industries collectively owned 37.55% of the voting stock, coupled with a staggered board and CEO/Chairman duality. Even when the dissidents were clearly out of patience with "excessive compensation paid to PFIN's Chairman and CEO" (13D filed by Lawndale Capital Management on P & F Industries in February 2010), major proposals submitted by the dissidents, who owned 7.42% of the voting stocks were rejected by management. This example suggests that even when the probability of being targeted in a proxy contest is high, management may not compromise by adjusting corporate policies unless there is a *credible* threat of losing the contest.