“May You Live In Interesting Times:”
The Transition from “Board-Centric” to “Shareholder-Centric” Corporate Governance And Its Implications for Auditors

By John C. Coffee, Jr.
Adolf A. Berle Professor of Law
Columbia University Law School

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“Remember, ‘accounting’ and ‘accountability’: nothing in common.”
I. Introduction

1. An organism that is well adapted to one environment will face stress (and even extinction) if that environment changes suddenly and sharply.
2. Example: a salt water fish is unlikely to survive in fresh water (and vice versa).
3. But organisms can also evolve to adapt to environmental changes.
4. Currently, the environment of corporate governance is changing rapidly. By now it has virtually become a cliché to say that we are moving from a “board-centric system” to a “shareholder-centric” system.
5. In this brief talk, I will first describe this transition, trace the prior transitions in the auditor’s environment in the United States, and finally focus on the strains and conflicts that are appearing.
6. My message is simple: the coming transition may blindside the auditor because the auditor is locked into an agent/principal relationship in which the principal may be changing. Caught in the middle, it may be exposed to pressure from both sides.
7. Let’s Start With Some History.
II. The Three Stages of Auditor/Corporate Interaction

1. Over a relatively short history, the auditor has existed in three very different environments in the United States:

   A. Debtor Capitalism

2. In the late 19th Century, the U.S. was a debtor nation that financed the growth of its trans-continental railroads and heavy industry by borrowing abroad.

3. Shareholders at this point relied on self-help remedies. Corporations in this era did not regularly publish financial statements. Instead, as late as the 1870s, it was common for committees of shareholders to visit the corporate offices to inspect the company’s books and records.

4. British investors began in the last quarter of the 19th Century to send their auditors (whose use was legally required in the case of British corporations) to inspect the records of American companies seeking to sell their bonds in Great Britain and to monitor their investments. KEY POINT: At this point, the “issuer pays” model did not apply, and auditors were paid by investors.

5. This invasion of British chartered accountants picked up in the 1880s, and the precursor of the AICPA was formed in 1887 (largely by British accountants). Price Waterhouse & Co. first sent its employees to the U.S. in the 1890s.

6. Gradually, procedures became regularized and financial statements became standard. The driving force behind this transition appears to have been investment banking firms (most notably, the House of Morgan) that specialized in selling bonds to British investors and in re-organizing bankrupt railroads. A secondary force was the New York Stock Exchange, which began to require annual audited financial statements (for newly listed companies only) around 1900. Companies associated with the House of Morgan (most notably, U.S. Steel) established higher standards for financial reporting (probably to reduce their cost of capital).
In this era, auditors were not serving managements, but were acting more as the agents of financial intermediaries who needed to raise capital from foreign investors. Those investors were understandably nervous of 19th Century American Robber Barons (e.g., Gould, Drew, Fisk et al.).

B. Managerial Capitalism

1. Eventually, the dispersion of share ownership arrived in the United States, as a result of (a) a merger wave in the 1890s, that was probably triggered by the Sherman Anti-Trust Act, (b) the efforts of the New York Stock Exchange to protect investors and provide mandatory disclosure, and (c) a stock market bubble in the 1920s. The Berle/Means “separation” of ownership and control was in full flower by the 1920s and probably peaked in the 1950s.

2. After World War I, the U.S. was no longer a debtor nation and did not need to attract foreign investors. Later, the Glass-Steagall Act curbed the power of the House of Morgan (and other investment banks). Companies came to finance themselves largely out of retained cash flow.

3. In this era, the auditor became subject to a new principal. Put bluntly, it was captured by management. Although the SEC gained legal power in 1934 to regulate the auditor, it largely deferred to self-regulation and peer reviews. Auditors were accountable only to management.
C. Shareholder Capitalism

1. As institutional investors came to dominate the stock market in the 1980s, they naturally sought a greater voice in management. Independent directors became a majority of the board, and eventually only one or two insiders remained on the board.

2. Independently, litigation risk grew, as securities class actions arose (largely because of the 1966 revision of the Federal Rules of Civil Procedure) and the “fraud on the market” doctrine (adopted by the Supreme Court in 1988).

3. Scandals (first, illegal payments in the 1970s resulted in the FCPA and then Enron and WorldCom in the 2000s produced SOX) ended self-regulation. An independent audit committee and stronger internal controls became standard by the 1980s. SOX both strengthened the audit committee and reduced management’s ability to seduce the auditor with lucrative consulting work.

4. Delaware law probably played an equivalent role in empowering shareholders by enabling a majority of the shareholders to remove the incumbent board without cause in most cases.

5. By 2000, a new pivotal actor—the Proxy Advisor (i.e., ISS and Glass Lewis)—appeared and reduced the transaction costs of shareholder collective action.

6. Beginning in the 1980s, incentive compensation (mainly stock options) better aligned managerial interests with shareholder interests.
III. Contemporary Activism

1. Two developments coincided in the 1990s: the rise of truly independent boards and the appearance of majority institutional ownership.

2. In 1950, institutional investors owned approximately 6.1% of the equity in U.S. public corporations. By 2005, this figure peaked at 53.3%. More importantly, at the largest 1,000 U.S. corporations, institutional ownership increased to 73% by 2009. This ownership was also highly concentrated with (by one SEC official’s estimate) the top 100 money managers controlling approximately 60% of the equity in these companies.

3. Board composition shifted similarly with truly independent directors exceeding 60% of the board by 2005.
The Rise of the Hedge Funds

1. Still, activism did not peak until the appearance of proactive hedge funds around 2005. Institutional shareholders—pension funds and mutual funds—held highly diversified portfolios (as required by law) and often their portfolios were “indexed.”

2. Their relatively thin staffs were focused on portfolio selection (“stock picking”) not shareholder voting or monitoring. Proxy contests were simply too costly, even with 1% ownership. In short, indexed investors tended to be passive investors.

3. In contrast, hedge funds are not diversified. Some hedge funds began to recognize that it was hard (maybe, close to impossible) to outperform the efficient market for the long-term. Thus, they sought an alternative strategy.

4. Their new strategy was to seek out underperforming companies, acquire a significant block (5% to 10%), and then attempt to force changes in the target’s management or business model or force it into a takeover or restructuring.

5. With this shift, shareholder activism moved from being primarily “defensive” (i.e., resisting management) to primarily “offensive” (i.e., they sought weak companies to change them).
ACTIVISM ON STEROIDS: The Rising Pace of Hedge Fund Activism

1. The phenomena of “activist” hedge funds buying stock in targets specifically to propose changes in business policies appears to date from around 2005 (Briggs 2007).

2. Over a 20 month period from 2005-2006, the first study counted 52 such campaigns (Briggs).

3. In contrast, the period from 2010 to early 2014 witnessed 1,115 “activist” campaigns.


5. At this rate, the majority of exchange-listed corporations could experience an activist campaign within another three to five years.
What Explains the Rise of Hedge Fund Activism?

1. Costs of proxy contests are **down** (deregulation)
2. Structural changes have also helped (decline of staggered boards, increased influence of proxy advisors, proxy access, etc.)
3. Profits are **up** (“activist” hedge funds are averaging a 13% return over the last ten years—more than double the 5.8% return for all hedge funds).
4. Correspondingly, the assets managed by “activist” funds have soared, growing from $23 billion in 2002 to $166 billion in $2014 and probably over $200 billion today. The top ten “activist” funds alone attracted $30 billion in 2013.
5. Best yet, a short-term gain on the filing of the Schedule 13D is relatively certain, with the abnormal gain averaging 6 to 7% across all studies (and more if a “wolf pack” is involved).
6. Bottom line: Costs Down, Profit Up, Gain is Relatively Riskless—But a Bubble could be developing as more and more activists chase fewer and fewer obvious targets.
How Successful is Proxy Activism?

1. Several recent studies place the “success” rate in proxy fights for activists at just over 75%

2. The actual number of proxy contests has declined—as managements have learned that it is better to settle than to fight (as even Martin Lipton concedes).

3. Revealingly, at those companies where activists win even one seat on the board, the CEO leaves within 18 months in 44% of the cases (for example, Sothebys).
One New Tactic
Probably Best Explains
Activists’ Success in
Proxy Contest—The
Wolf Pack

1. The “Wolf Pack” is a loose association of hedge funds (and some other institutions) that carefully avoid forming a “group” for purposes of §13(d)(3) of the Williams Act, but share a common goal and often have advance knowledge of the impending filing of a Schedule 13D by the wolf pack’s leader.

2. Those forming the “wolf pack” can tip prospective allies of their plans because no fiduciary breach is involved (rather, their own institution’s interests are furthered); thus, this use of material, non-public information does not amount to insider trading. Norms of reciprocity may develop: “You tip me, and I will tip you.”
3. The following diagram illustrates the characteristic pattern and shows the abnormal trading during the ten day “window” preceding the Schedule 13D filing:

The Wolf Pack Has Altered Prior Practice, and the Resulting Balance of Advantage in the Following Respects:

A. The Wolf Pack Acquires a Larger Stake: 13.4% as compared to 8.3% by other activists (See Becht, Franks, Grant and Wagner). And This May Understate, Because Silent Allies Need Not Disclose

B. The announcements of a “wolf pack” engagement produces more than twice as high an abnormal market return (14% to 6% for other activists—Becht, Franks, Grant and Wagner).

C. The probability of a “wolf pack” achieving at least one of its intended goals is much higher (78% versus 46% for other activists).

2. As money flows into activist hedge funds, these disparities seem likely to increase, as larger stakes can be acquired.

3. How much can a wolf pack acquire? In the Sotheby’s litigation, proxy solicitors testified that hedge funds then held an estimated 32.8% of Sotheby’s. This is a virtual control block.

4. Most recently, in the DuPont proxy contest last month, DuPont won a narrow victory (i.e., 52% to 48%), despite (1) a $68 billion market capitalization; (2) a long record of regularly outperforming the S&P 500 index; and (3) a flexible CEO who accommodated many of the insurgent’s demands (and spun off a major division, as requested by them).

5. **Bottom Line:** No firm is “too big to challenge,” and even Apple and Microsoft have recently settled with activists who wanted them to tap their large cash hoards and increase the payout to shareholders.
IV. What Do Activists Want?

1. Activists generally seek to do one of the following:
   a. curb perceived managerial “empire building” by disposing of non-core assets;
   b. increase shareholder payout through dividends and stock buybacks;
   c. increase leverage to fund increased payouts;
   d. impose “investment-limiting” restrictions that limit capital expenditures (and particularly investment in research and development);
   e. eliminate takeover defenses, such as the staggered board and the poison pill; and
   f. put the company up for sale.

2. Hedge Fund Activists Have a Short Span of Attention and Usually Exit the Target Firm Within One Year of the Filing of their Schedule 13D. But the impact of restructurings and leverage increases lasts longer.
Impacts

1. **Short Versus Long-Term**: All studies find a short-term abnormal gain of 6% to 7% on the filing of a Schedule 13D. But most studies find no long-term gains, except when there is a takeover bid or a restructuring (see Becht, Franks, Grant and Wagner). Only one study (Bebchuk) finds any post-intervention improvement in operating performance.

2. **Wealth Transfers**: Several studies find hedge fund interventions transfer wealth from bondholders to shareholders (Klein and Zur 2011), and one study finds that employees also suffer through wage stagnation.

3. **Accounting Researchers** (most notably, Wharton’s Brian Bushee) have found that composition of the firm’s shareholders affects the firm’s investment horizons. If a firm is “predominately” owned by “transient institutions,” the likelihood increases “that managers cut R&D to manage earnings.”

4. **Research and Development.** Allaire and Dauphin find, using the FactSet database, that in the four-year period following a hedge fund “engagement,” R&D expenses at “surviving” target firms decline by more than 50% (expressed as a percentage of sales):

5. Moreover, their figure may understate the R&D decline, as it does not include the likely R&D decline at firms that are taken over.

6. **Recent High Visibility Examples Show the Urge to Cut R&D:**
   A. Valeant/Pershing Square announced an intent to reduce the research budget at the combined Allergan/Valeant firm by over 70% if the merger was successful.
   B. Trian publicly sought to cut R&D at DuPont and to shut its central research facility.

7. The counterview is that, although the amount of R&D expenditures clearly decrease following a hedge fund engagement, the return on and profitability of such expenditures increases. (Brav 2015).
1. For better or worse, a revolution may be in progress within the public corporation, of which hedge fund activism is only the spearhead.

2. As a 2015 study by the Roosevelt Institute summarized:

   “In the 1960s, an additional dollar of earnings or borrowing was associated with about a 40-cent increase in investment. In recent years, the same dollar is associated with less than 10 cents of additional investment.” See J.W. Mason, Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment (2015).

3. From the second half of 2009 through 2013, the Federal Reserve’s Flow of Funds data shows that corporate investment increased by $400 billion, while shareholder payouts increased by $770 billion and corporate borrowing by nearly $900 billion. In effect, corporate borrowing is primarily funding shareholder payouts, not investment (Id.).

4. Hedge fund activism did not cause this imbalance, but it appears to be accelerating it.

5. Activists believe they are enforcing an “optimal” investment policy, but the larger question arises whether the public corporation in the 21st Century can fund R&D or even retain its capital.
How is Hedge Fund Activism Changing Corporate Governance?

I. The Old “Board-Centric” Model
1. Directors Act as a Collegial, Deliberative Body.
2. Directors Do Not Have Staffs.
3. Directors Paid Only by the Corporation in Cash or Stock.

II. The New “Shareholder-Centric” Model
1. Fragmented Boards. The board may be divided with several insurgent directors either elected in a proxy contest or added in a settlement with activists.
2. Blockholder Directors. Directors appointed or elected by insurgents may come with a special agenda and loyalties.
3. Outside Compensation. A few activists separately pay their directors. Others appoint employees of the hedge fund who are already compensated by the hedge fund (and simply change their assignments).
4. Special Staffs. Hedge funds arm their directors with consultants and staff (including accountants) and prepare “white papers” for the rest of the board.
5. Confidentiality. Blockholder directors share information with the hedge funds that appointed or elected them. Although all directors are subject to a duty of confidentiality at common law, they will generally not sign a confidentiality agreement.
6. Board Meetings. Blockholder directors may seek to bring their staffs (or at least their legal counsel) to board meetings. Target corporations may respond with bylaws blocking their attendance.
V. Where Does the Auditor Get Caught in the Middle?


2. Until Recently, Proactive Investors’ Main Goal Was Representation on the Board. Now, their Focus has Shifted to the Boards’ Committees. To Date, They Have Primarily Sought Representation On the Nominating and Executive Committees, and Have Shown Little Interest in the Audit Committee.

3. This May Change As Activists Want to Utilize “Rainy Day” Reserves and Free Cash Flow to Fund Shareholder Payouts. (Those who wish to pay out “free cash flow” have an incentive to inflate earnings and read bond covenants narrowly. Although bondholders cannot sue the auditor for “aiding and abetting” management’s fraud, they can sue for allegedly materially misstated financial statements—hence, possibly increased litigation risk?).
4. What Will Activists Seek to Do?

Their Options Include:

a. **Direct Contact With the Auditor.** Proactive investors regularly contact and meet today with independent directors. Similarly, they may wish to meet with the auditor in order to test ideas they have for restructuring the firm or increasing leverage. At present, the auditor would likely object that it owes a duty of confidentiality and might even be implicated in insider trading by the proactive investor if it divulged arguably material information. But resistance is harder if a director asks, as directors have broad rights to see all corporate data.

b. **Information About Free Cash Flow.** Managements sometimes create “rainy day” reserves to facilitate earnings management and avoid volatile earnings fluctuations. Proactive investors may wish to empty these reserves, but first they have to find them. Here again is an area where investors want information that management does not want released.

c. **The “Insurgent-friendly” Auditor.** Imagine a pending proxy fight between insurgents and management. Insurgents have a realistic shot at victory but are willing to settle for a minority slate (at least this year). As the price of settlement, however, they demand some changes, including a more friendly and accessible auditor. One can imagine insurgents identifying a “friendly” auditing firm and perhaps some accounting firms marketing themselves as “friendly” (probably not one of the Big Four) in order to gain such assignments as a replacement auditor.

d. **Auditor Rotation.** Insurgent investors—think of Carl Icahn—may well want to embarrass the incumbent management. To do so, they may assert that the audit committee is too “cozy” with management, that the auditor has been in office since the last Ice Age (allegedly because it will not challenge management), that the auditor has accepted dubious managerial judgments or estimates, or that further disclosures should be made by the auditor. Auditors will not enjoy getting caught in this cross-fire and may seek to keep a low profile.

e. **The Blockholder Director on the Audit Committee.** Assume that, as a result of negotiation, activists place a nominee as a director on the audit committee. As a director, this nominee raises questions about (1) whether some reserves are excessive; (2) the maximum dividend or stock buyback that can be made without violating bond covenants; and (3) possible spinoffs of assets. This director may be assisted by an accounting staff hired by the hedge fund.
VI. Likely Scenarios for Engagement

1. “Engagement” is the new buzzword, and The Conference Board has recently published “Guidelines for Engagement” for institutional investors and directors.³

2. The most likely party to “engage” the auditor—either to seek additional information or an expanded report—will be not an activist hedge fund, but a proxy advisor. Proxy advisors now regularly “engage” independent directors and evaluate shareholder proposals involving auditors. This more polite scenario lessens any prospect of insider trading or selective disclosure.

3. Today, ISS will not recommend a vote to approve the auditor’s appointment if the auditor receives non-audit fees in excess of its audit and tax compliance fees (with certain exceptions for IPOs).⁴ Conceivably, ISS may add additional criteria to what it expects from the auditor. Possibly, it may ask for disclosure of the identity of the lead audit partner (whether or not the PCAOB requires this).

4. Although the auditor may “stonewall” this approach, it also knows that, if there were a control fight and if it is perceived to be on management’s side, it may be replaced in the wake of a control change. Remember that CEO Turnover Is Likely in the Wake of a Successful Proxy Fight. Under pressure, proxy advisors may change their voting recommendations, targeting for replacement audit committee members who approve substantial non-audit services or who refuse to rotate the auditor.

5. As a defense, management, itself, may wish to stage meetings between the auditor and the corporation’s major institutional investors in order to show its openness and willingness to accommodate. This has been the recent strategy of management in dealing with an ISS negative voting recommendation.

6. Shareholder Advisory Committees (“SACs”): These have been formed in a number of cases, and managements today can seldom risk not “engaging” with institutions. Suppose such a committee is organized by proactive hedge funds holding a large block and staffed with investment bankers and accountants. It seeks to increase shareholder payout and wishes to meet with the auditor and the audit committee to discuss increased leverage and buybacks. The SAC presents its views on the maximum permissible spinoffs or stock buybacks and asks the auditor to confirm.

VII. The Barometer of Change

Over time, the auditor may increasingly find itself between the rock and the hard place. Long pressured by managements to inflate earnings, they will now face pressure from shareholders to increase payout and resistance (and even litigation) from creditors. At the large firm, auditor tenure is fairly secure. One 2012 study finds that 59% of Fortune 100 firms have had the same auditor for over 10 years and 37% for over twenty years.³ Auditor rotation is more likely at smaller firms, but the efforts of proactive investors have not focused there and have been largely directed at larger firms (where break-ups and spin-offs are more likely because of the prospect for negative synergy).

Today, the annual rate of auditor replacement is around 10% (but lower at the larger firms). Watch to see if this rate changes, because it may be the best measure of how shareholder activism is impacting the auditor. Disruption is the new normal.

³ See Kate Iannelli, Mandatory Audit Firm Rotation: Explaining the Key Numbers (NACD Directorship (March 22, 2012)).