# Corporate Finance Theory

## Lecture 18

## Soft shareholder activism

## *Levit* (2019)

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# Intended outcomes for the day:

1. **To describe** how the conflict between an activist investor and the board in Levit (2019) can reduce shareholder value, by hindering communication

2. **To analyze** how the activist's ability to exit can potentially make communication more effective.

3. **To evaluate** whether Levit (2019)'s way of modelling shareholder and board preferences is a good fit for real-world examples of oil companies, institutional investors, and climate change.

# Corporate Governance

Quote from Jean Tirole: ”Corporate Governance”, Econometrica (2001), p. 1-2

THE STANDARD DEFINITION of corporate governance among economists and legal scholars refers to the defense of shareholders' interests. Classical economists, from Adam Smith (1776) to Berle and Means (1932), were concerned with the separation of ownership and control, that is with the agency relationship between a "principal" (investors, outsiders) and an "agent" (manager, entrepreneur, insider). There is now widespread awareness that managers, say, may take actions that hurt shareholders. They exert insufficient effort when overcommitting themselves to external activities, when finding it convenient to accept overstaffing, or when overlooking internal control. They may collect private benefits by building empires, enjoying perks, or even stealing from the firm by raiding its pension fund, by paying inflated transfer prices to affiliated entities, or by engaging in insider trading. Last, they may entrench themselves by investing in mature or declining industries that they are good at running, by taking risk that is either excessive (as when their position is endangered) or

# Corporate Governance (continued)

Quote from Jean Tirole: ”Corporate Governance”, Econometrica (2001), p. 1-2

insufficient (as when it is secure), or by bending over backwards to resist a takeover.

This basic agency problem suggests a possible definition of corporate governance as addressing both an adverse selection and a moral hazard problem. A good governance structure is then one that selects the most able managers and makes them accountable to investors. This widely-held view can, for example, be found in Shleifer and Vishny's (1997) survey of the topic; they define corporate governance as "the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment."[2] For most economists and legal scholars, the debate is more about how to *implement* shareholder value than about its legitimacy.

# Introduction

Many conflicts of interest throughout the semester:

- Creditors and shareholders
- Shareholders and workers
- Insiders and outside investors

Levit (2019) focuses on:
- Conflict between an activist investor and board of directors
- Can reduce shareholder value

**Moral hazard** (hidden actions)

vs

**Adverse selection** (hidden information)

# Introduction (continued)

Board must choose between making a change or keeping the status quo

Change is risky: shareholder value known to the activist, not to the board. ”State: $\theta$”

Board is biased towards the status quo

Activist can communicate, possibly convince the board to make a change. But talk is cheap!

Following the board’s decision, the activist can:

- Do nothing
- **Exit:** sell shares
- **Use Voice:** launch a public campaign

# Example: exit

## Norwegian fund drops Exxon, Chevron over climate lobbying

By The Associated Press
Mon., Aug. 24, 2020 | 1 min. read

BERLIN - A Norwegian pension fund said Monday that it is divesting over $47 million from 27 companies, including Exxon and Chevron, as part of its commitment to combating climate change. The fund warned other major oil and gas companies it might drop them as well.

Storebrand, which manages assets worth $91 billion, had over $12 million invested in Exxon and more than $10 million in Chevron. It said it is also selling its stocks in U.K.-based mining company Rio Tinto and German chemicals maker BASF.

The Oslo-based fund called climate change "one of the greatest risks facing humanity" and accused several of the companies it is divesting from of "lobbying activities which undermine action to solve this crisis."

"The Exxons and Chevrons of the world are holding us back," Storebrand's chief executive, Jan Erik Saugestad, said in a statement. "This initial move does not mean that BP, Shell, Equinor and other oil and gas majors can rest easy and continue with business as usual, even though they are performing relatively better than U.S. oil majors."

# Example: voice

## For first time ever, majority of shareholders push oil giant Chevron to align with Paris climate pact

Published: June 24, 2020 at 10:01 a.m. ET

By Rachel Koning Beals

www.marketwatch.com

Notably, a 53% majority of shareholders at Chevron Corp. CVX, +0.31% voted for a resolution seeking a commitment from the oil giant to align its climate-policy lobbying activities with the goal of the Paris Agreement, an international voluntary effort that aims to keep global average temperature rise to below 2 degrees Celsius, and ideally limit it to 1.5 degrees.

*'Lobbying that is inconsistent with the goals of the Paris Agreement presents a direct threat to our portfolios, our economies, and our clients.'*

— Adam Kanzer, head of stewardship for the Americas, BNP Paribas Asset Management

Filed by Climate Action 100+ investor signatory BNP Paribas Asset Management, this was the first climate-related proposal ever to win a majority of Chevron shareholder votes and it was the only proposal on Chevron's 2020 proxy ballot that won a majority, Climate Action 100+, a group of more than 450 leading asset managers, pension funds and others with a combined $40 trillion in assets, said in a Tuesday release.

# Example: (also) dialog

## Denmark's P+ shakes up responsible policy, divesting fossils

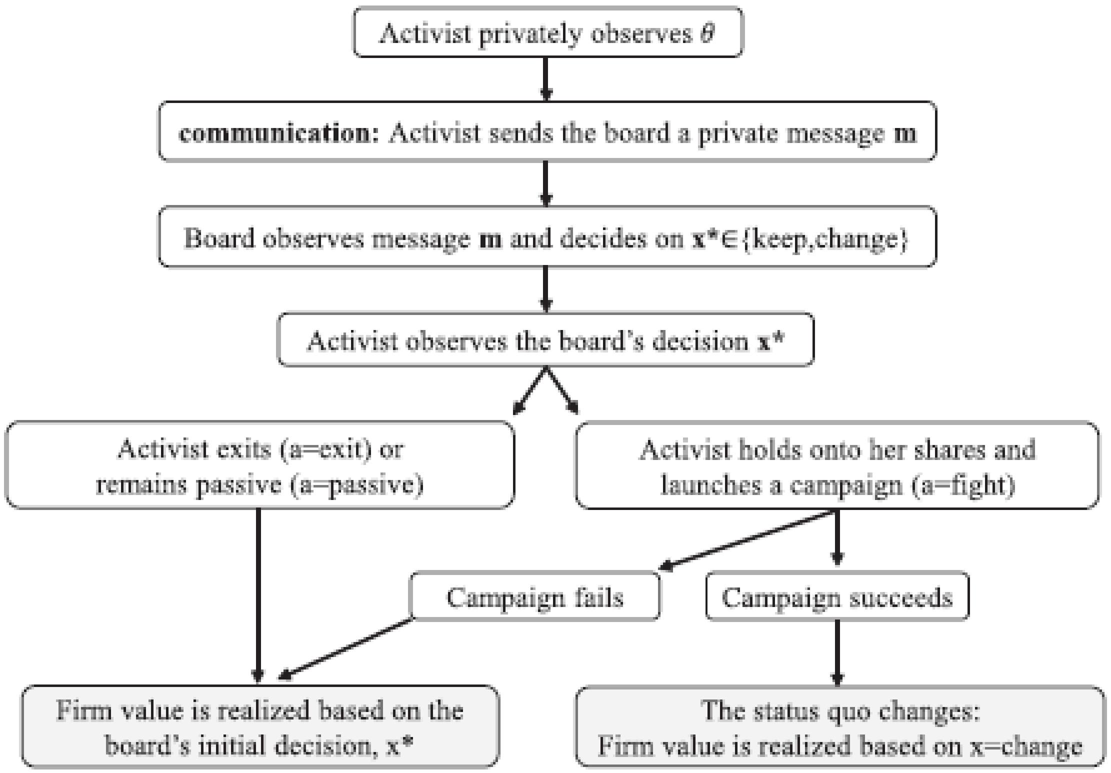
BY RACHEL FIXSEN | 5 NOVEMBER 2020 www.ipe.com

Denmark's P+ is setting a climate goal for all investments – carbon neutrality by 2050 – and said it will lower its threshold for the exclusion of companies failing to meet its expectations, as part of a series of changes to the pension fund's sustainable investment approach.

Eldrup said the pension fund believed that dialogue and active ownership could create real change, and that it was P+'s primary tool.

But he added: "If the companies in our portfolio refuse to enter into a dialogue with a view to restructuring, we will divest the shares."

# Model: players, actions, timing



# Model: more details

**State:** θ, distributed on $[0, \infty)$, according to pdf f and CDF F

- captures shareholder value of ”change”, private information of activist

**Message:** activist message strategy μ(θ)

- for given θ, message sent to the Board is m = μ(θ)
- Message space $[0, \infty)$, costs ε, vanishingly small
- For the sake of the lecture, assume
  - 1) activist can also send costless message: ”silent”
  - 2) out of equilibrium beliefs given by prior, CDF F

**Board actions:** taken after receiving a message

- x = keep or x = change

**Activist reaction:** i) nothing, ii) exit, iii) voice

- voice only suceeds if shareholders are on board:

$$E(\theta | m) > \textit{Shareholder value from "keep"}$$

# Model: payoffs

**Shareholders:**

$$v(\theta,x)=\begin{cases}\underline{\theta} & if\ x=keep\\ \theta & if\ x=change.\end{cases} \quad (1)$$

**Activist:**

- $\alpha v(\theta,x)$ if no exit, no campaign; where x chosen by Board
- $\alpha p$ if exit
- $\alpha v(\theta,x') - c$ if no exit, then campaign; x' maximizes shareholder value, conditional on message m sent by the activist and decision to have a campaign.

**Board:**

- $\omega v(\theta,x) + \beta$ if outcome is x = keep
- $\omega v(\theta,x)$ if outcome is x = change
- Reputation cost, if campaign gives outcome $x' \neq x$:

$$\kappa\left(\theta-\underline{\theta}\right),\ \text{where}\ \kappa \geq \omega.$$

# Model: payoffs (normalized)

**Shareholders:**

$$v(\theta,x)=\begin{cases}\underline{\theta} & if\ x=keep\\ \theta & if\ x=change.\end{cases} \qquad (1)$$

**Activist:**

- v(θ,x′) if no exit, no campaign; where x chosen by Board
- p if exit
- v(θ,x′) - c if no exit, then campaign; x′ maximizes shareholder value, conditional on message m sent by the activist and decision to have a campaign.

**Board:**

- v(θ,x) + β if outcome is x = keep
- v(θ,x) if outcome is x = change
- Reputation cost, if campaign gives outcome x′ ≠ x:

$$\kappa\left(\theta-\underline{\theta}\right), \text{ where } \kappa\geq\omega.$$

Under prior beliefs F, Board prefers ”keep” to ”change”: $\mathbb{E}[\theta]\leq\underline{\theta}+\beta,$

# Question: modelling of preferences

Levit (2019) assumes that:

Activist and shareholder interests are **aligned**
- Activist just cares about shareholder value
- Caveat: private costs of campaign, activist better informed

Activist and Board interest are **not aligned**
- Board does not just care about shareholder value
- Extra motive: biased towards the status quo.

**Question:** is this way of modelling activist, shareholder, and board preferences, a good fit for the type of examples seen earlier in the lecture (oil companies, pensions funds, climate change? Why or why not?

**Discuss, then go to socrative.com, room 897458 and write a short answer.**

# Discussion

# Ineffective communication

**Proposition 1.** A babbling equilibrium always exists. There is $\overline{\beta} > 0$ such that if $\beta > \overline{\beta}$, then in any babbling equilibrium the board keeps the status quo and the activist launches a successful campaign with a strictly positive probability.

A **babbling** equilibrium is one in which no communication takes place.

Let $M \subset [0, \infty)$ denote the set of messages sent with strictly positive probability, according to $\mu(\theta)$.

Then, in a babbling equilibrium:

$$E(\theta | m) = E(\theta), \; \forall\, m \in M.$$

E.g. activist sends message $\mathrm{m} = \mu(\theta) = \text{"}Silent\text{"}, \forall\, \theta \in [0,\infty)$;

with out of equilibrium beliefs, conditional on receiving any $m \neq silent$ , that $\theta$ is distributed according to CDF F

# Ineffective communication (continued)

Apply Bayes' Rule:

The Board will choose x = keep, maintain the status quo.

Shareholder value:

# Communication without voice or exit

**Definition 1.** An equilibrium is influential if there exist $\theta' \neq \theta''$ such that $\mu^*(\theta') \neq \mu^*(\theta'')$ and $x^*(\mu^*(\theta')) \neq x^*(\mu^*(\theta''))$.

For different values of the state, the **activist** sends different messages, and these message induce different **Board** actions

Recall that the Board chooses between x = keep and x = change, where

$$\mathbb{E}[\theta] \leq \underline{\theta} + \beta,$$

Thus, in an influential equilibrium, the activist sometimes **persuades** the Board to make a change.

# Alignment of interests

The Board prefers to make a change if:

$$\theta > \underline{\theta} + \beta$$

Shareholders prefer a change if:

$$\theta > \underline{\theta}$$

Thus, shareholders and the Board sometimes disagree about the best course of action.

# Influential equilibrium

The Board prefers to make a change if: $\theta > \underline{\theta} + \beta$

The activist prefers a change if: $\theta > \underline{\theta}$

In an influential equilibrium, there are messages, $m = \mu(\theta)\ and\ m' = \mu(\theta')$ such that:

$$E(\theta |\ m) < \underline{\theta} + \beta < E(\theta |\ m')$$

Let M denote the set of all such messages m, and M' the set of all such messages m'. Note that M = { Silent }, here.

Thus, the activist demands a change (i.e. sends m $\in M'$) if and only if $\theta > \underline{\theta}$

# Influential equilibrium

The Board prefers to make a change if: $\theta > \underline{\theta} + \beta$.

The activist prefers a change if: $\theta > \underline{\theta}$.

Thus, the activist demands a change (i.e. sends m ∈ $M'$) if and only if $\theta > \underline{\theta}$.

If $\beta \leq \mathbb{E}[\theta - \underline{\theta} | \theta > \underline{\theta}]$. then the Board always accepts the demand.

- Influential equilibrium: communication!
- Expected shareholder value:

If not, then the Board's best response to any message is to keep the status quo.

- No influential equilibrium: no communication!
- Shareholder value:

# Figure to illustrate

# Communication with Exit

Suppose that after the Board's decision, the activist can exit by selling shares at price p.

In particular, assume p > $\underline{\theta}$
i.e. share price attractive relative to status quo.

Implication:

If the Board chooses keep, then the activist exists
If the Board chooses change, then the activist exists if and only if $\theta$ < p .

Thus, for any $\theta$ < p, the activist knows he will exit no matter what: and therefore will choose m = silent: costless.

# Communication with Exit (continued)

Recall:

**Definition 1.** An equilibrium is influential if there exist $\theta' \neq \theta''$ such that $\mu^*(\theta') \neq \mu^*(\theta'')$ and $x^*(\mu^*(\theta')) \neq x^*(\mu^*(\theta''))$.

The Board wants to make a change if:

The activist wants to make a change if:

Thus, the activist demands a change (i.e. sends m ∈ $M'$) if and only if:

The Board always accepts the demand if $\beta \leq \mathbb{E}[\theta - \underline{\theta} | \theta > p]$.

- Influential equilibrium: communication!
- The possibility of exist makes communication more credible!

# Figure to illustrate

# Intended outcomes for the day:

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# Preparation Guidelines

<u>Lecture 19</u>

We will focus on:

communication with voice (Section 2.4)
communication with both voice and exit (Section 2.5).

I will also go through a very brief review of the semester.

Moreover, think about the following question:

Which idea from the theory we've seen this semester is the **BEST** (i.e. most interesting/relevant)? Which idea is the WORST (i.e. least interesting/relevant)?

**Be ready to share your thoughts**