US Investors – From Courthouse to Boardroom

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The Growth of Activist Investors and their Use of US Courts to Influence Corporations and Maximize Value

- The SEC's deregulatory initiatives of the early 1990s allowed investors to become more effective shareholder activists. Accordingly, shareholder activism has expanded significantly over the past 30 years.
- There are a variety of activist investors, from hedge funds that lobby for structural changes, to labor union and public pension funds that are attempting to improve corporate governance.
- One increasingly successful option for shareholders is to use the US court system to bring about desired changes.

Activist Investors Are Often Perceived as the Enemy of Shareholder Value

- There is a common perception that activist investors are the enemy of long term shareholder value. "There is a danger that activist stockholders will make proposals motivated by interests other than maximizing the long term, sustainable profitability of the corporation." Chancellor Strine, Delaware Court of Chancery (2011).
- A J.P. Morgan report on shareholder activism concluded that from the start of 2001 until almost the end of 2014, 47% of all activist hedge funds campaign positions were held for under six months and 68% were held for under a year. Only 8% of all campaigns led to hedge funds holding the position for more than three years.
- S&P Global Market Intelligence found that 40% of activist investors either reduce or completely relinquish their positions in the target company in just a quarter after making investments.
- When activist investors bully management, economic growth can suffer. Pushing for dividends and buyback shares means the company cannot use the funds to invest in growth.
- Icahn Associates LP took a stake in Apple in 2013, stating the company had long-term value and that it would "dominate" new product categories. However, instead of pushing for more investment in these new categories, Icahn pushed for more stock buybacks and dividends. Then, following a quarterly earnings decline, Icahn sold all of his shares in the company

Negative Effects of Shareholder Activism

- Activist shareholders can use the US legal system to the detriment of the companies in which they invest.
- Lawsuits by activist investors can distract management from the efficient running of corporations.
- In 2013, activist investor David Einhorn of Greenlight Capital filed a lawsuit to attempt to stop an Apple shareholder vote concerning the issuance of a form of stock. CalPERS opposed the lawsuit, which Apple's CEO called "a silly sideshow". By filing the lawsuit, Einhorn attempted to take away from shareholders the right to decide whether Apple should issue the new stock. Einhorn ultimately dropped the lawsuit.

However, Activist Investors Can Use the US Courts for Good

- Some large pension funds are using the US legal system to behave like activist investors. By engaging in litigation where appropriate, institutional investors can bring about changes, recover increased compensation and demonstrate to their clients that they are seeking to maximize value.
- For example, the California Public Employees' Retirement System (CalPERS), the US's largest public pension fund with more than 207 billion USD in assets, has been active in pursuing corporate reforms.
- Finance Professor Brad Barber analyzed the gains from CalPERS's high-profile activism from 1992 to 2005. Prof. Barber estimates that CalPERS' activism has resulted in:
    - Total short-term wealth creation of 3,1 billion USD between 1992 and 2005.
    - Long-run benefits could be as high as 89,5 billion USD.
- CalPERS has been able to use its efforts to obtain positive publicity:
    - "This money belongs to our members and will be put back to work to ensure their long-term retirement security." CalPERS Chief Executive Officer Anne Stausboll, following 301 million USD settlement with Standard & Poor's.

Securities Class Actions Can Lead to Positive Industry-Wide Changes: Yahoo, Inc.

- In January 2017, investors initiated litigation against including Yahoo, Inc. for its failure to disclose several large data privacy breaches. The case settled in 2018 for 80 million USD and was the first significant securities fraud settlement from a cybersecurity breach.
- As the case settled, on 21 February 2018, the SEC issued interpretive guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents.
- SEC Chairman Jay Clayton stated: "I believe that providing the Commission's views on these matters will promote clearer and more robust disclosure by companies about cybersecurity risks and incidents, resulting in more complete information being available to investors. In particular, I urge public companies to examine their controls and procedures, with not only their securities law disclosure obligations in mind, but also reputational considerations around sales of securities by executives."

Activist Investors Can Use the US Courts to Improve Corporate Governance

- Pension fund "activism and engagement has stepped up quite a bit more as a result of the financial crisis when we all lost a lot of value. As universal owners, how can we not assert our rights and develop a relationship with companies in our portfolio?" Anne Sheehan, director of corporate governance at CalSTRS.
- Investors have been able to create long-term shareholder value through litigating for corporate governance reforms:
    - "We are delighted with this final approval. We are well on our way to our goal of recovering significant compensation for the members of the class. In addition, Homestore has agreed to ***unprecedented corporate governance protections for current stock holders***." CalSTRS Chief Executive Officer Jack Ehnes (following 93 million USD settlement with Homestore.com Inc.).

Shareholder Derivative Cases and Improved Corporate Governance: *CalPERS v. InterActiveCorp.* (Del. Ch. 2016)

- "Dual-class" or "multi-class" stock structures diminish the voting power of institutional and individual investors.
- IAC Chairman Diller owned less than 8% of the company's stock, but he and his family controlled more than 44% of IAC's voting power through control of all outstanding super-voting Class B shares.
- Diller asked the board to approve the creation of non-voting Class C stock and then issue one share of nonvoting Class C stock for each share of common stock and Class B stock.
- The suit alleges a breach of fiduciary duty against the board and against Diller, and seeks an injunction against the issuance of Class C stock.
- After months of contentious litigation, defendants effectively conceded the case by abandoning their plan to entrench Diller's control of the company by issuing a new class of non-voting stock.
- CalPERS achieved a significant victory for shareholders' core right to vote.
  - Anne Simpson, investment director for sustainability for CalPERS: "It's critical to the healthy functioning of our capital markets for large institutional investors like CalPERS to take a stand against this sort of abuse of corporate control."

Merger and Acquisition Litigation Can Maximize Shareholder Value

- Institutional investors may also challenge mergers and acquisitions that they believe fail to maximize shareholder value.
- In such actions, the target company is alleged to have failed to conduct a sufficiently competitive sale, created restrictive deal protections that discouraged additional bids or failed to disclose information about the sales process and the financial advisor's valuation.

In re El Paso Corp. Shareholder Litigation (Del. Ch.)

- In connection with the sale of El Paso Corporation to Kinder Morgan, Inc., El Paso's CEO failed to disclose that he had an interest in purchasing some of the El Paso business back from Kinder.
- El Paso used Goldman, Sachs & Co. as its financial advisor for the transaction despite the fact that Goldman owned 4 billion USD of Kinder stock and had two principals on the Kinder board.
- Following litigation, El Paso paid a $110 million settlement to resolve the shareholder class members' claims and Goldman did not receive its $20 million advisory fee. Goldman acknowledged that the lawsuit was a contributory cause to it agreeing to waive its advisory fee.
- As a consequence, banks who advise the boards of target companies in merger acquisitions have implemented reforms to their conflict of interest policies, including disclosing their personal shareholdings before working with clients.

Recent Developments in US Securities Litigation Mean Investors Must Pay Close Attention

- US class actions and shareholder litigation are perhaps the most potent means of achieving corporate governance worldwide.
- Institutional investors are automatically included in US securities fraud class actions if they purchased the relevant securities during the class period and suffered damages as a result of the fraud. This magnifies the efforts of the lead plaintiffs.
- Recent Supreme Court rulings have limited the use of class actions so that interested investors should pay particular attention to cases in which they have suffered significant losses.
- In particular, institutional investors should consider filing individual actions early when their losses are significant and their interests potentially compromised.
- Simply waiting for a case to settle and file a claim form is no longer sufficient. Institutional investors that simply file claims at the end of a case are missing opportunities to market themselves to their clients as actively seeking maximum returns and in some instances may miss out on any recovery at all.

California Public Employees' Retirement System v. ANZ Securities (2017)

- Represents a change in US law that further reduces shareholders' ability to seek and obtain compensation for losses sustained through securities fraud in class actions.
- The Supreme Court ruled that statutes of repose are no longer suspended (or "tolled") after a class action is filed. This ruling has undone years of precedent whereby a shareholder with significant losses whose claims were being prosecuted in the class action could wait for the class action settlement to be proposed to the court to determine if it is economically beneficial to "opt-out" of the class and file an individual case or file a settlement claim.
- Now, institutional investors with significant losses will in many cases now have to decide (1) whether to seek to control the litigation from the beginning as a lead plaintiff to ensure their interests are fully protected; or (2) file individual actions "on time", namely before the class settlement has been proposed, to avoid the running of the statute of repose.
- Institutional investors that simply file claims at the end of a case are missing opportunities to market themselves to their clients as actively seeking maximum returns and in some instances may miss out on any recovery at all.

China Agritech Inc. v. Resh (2018)

- The Supreme Court ruled that a class action cannot be refiled after the statute of limitations has passed.
- Previously, the filing of the first class action tolled the statute of limitations, allowing subsequent actions to be filed outside of the normal time limits.
- The consequence of this decision is that if the lead plaintiff is deemed unsuitable, had filed claims on bases the presiding court deemed procedurally inappropriate or made procedural errors that lead to the dismissal of the class action, re-filing will not be permitted if the statute of limitations has run.
- It is likely that certain class actions will be dismissed and no other lead plaintiff will be able to pursue the claims, thus leaving only those investors who timely filed individual actions as eligible to receive compensation.
- Refiling of class actions that were dismissed for technical reasons is no longer possible after the statute of limitation has passed, even if the procedural grounds could be cured in the amended complaint.

The Effects

Institutional investors with very significant losses who are not lead plaintiffs would be wise to monitor the underlying litigation carefully and be prepared to file an individual case should the class action appear to be compromised or in danger of dismissal.

We expect a significant number of cases to be dismissed and class periods narrowed.

INDIVIDUAL ACTIONS: What they are

An individual action is a case in which an investor pursues litigation against an issuer defendant to seek compensation for losses sustained through securities fraud.

These actions, when in the US, are generally pursued parallel to class actions.

INDIVIDUAL ACTIONS: Why you file them

- **Goal is to determine if lead plaintiff's interests are aligned.**
- **If lead plaintiff's trading patterns are different, an individual action may be recommended.**
- **To gain control over litigation strategy and settlement negotiations.**

  Example: To the extent permitted by law, an individual action allows control over the time frame of the claim's period.

  This is often different than the "class period". Class periods may be too long or too short to protect an investor's interests.

INDIVIDUAL ACTIONS: Why you file them

Example: Securities Act of 1933 ('33 Act) claims

Certain claims that arise out of the'33 Act may not be available in class as those claims may not be pursued on a class basis.

Investors with claims pursuant to the '33 Act are often well advised to file individual actions, significantly increasing the amount of compensation available.

INDIVIDUAL ACTIONS: Why you file them

- **To access claims ineligible for inclusion in the class action**

Example: *Vivendi S.A.* (Vivendi)

In *Vivendi*, compensation is available only to those shareholders who filed an individual action.

Example: *Morrison v. National Australia Bank* (Morrison)

Morrison excluded purchases on non-US exchanges.

INDIVIDUAL ACTIONS: When you file them

- **In instances in which compensation will only so be available.**
- **In instances where an investor has suffered a significant loss.**
  - Most investors determine, as a general rule, the minimum size of loss
  - It is generally not recommended when losses are under 10 million USD.

Additional benefits

- **Faster distribution of settlement funds:**

  Individual settlements are paid immediately.

  Class action settlements can take 2 years to distribute.

In re Merck & Co., Inc., Securities, Derivative & "ERISA" Litigation

- **To access claims not litigated in the class action**

  In the Merck case, individual plaintiffs had access to the following state law claims that would not be pleaded in the class action in federal court:

  (1) common law fraud for inducing plaintiffs to purchase Merck securities;

  (2) common law fraud for inducing plaintiffs to hold Merck stock after they had purchased it; and

  (3) negligent misrepresentation for inducing plaintiffs to purchase Merck stock.

Individual claimants recovered significantly more compensation than class members, with some individual claimants receiving in excess of one million USD more than they would have received if they had remained as passive class members.

Vivendi S.A.

- Following the dismissal of the US class action following the *Morrison* decision (that prohibits investors suing in US courts for securities purchased on non-US exchanges), we filed individual actions in France.
- Compensation is available only to those shareholders that filed a timely individual action.
- Investors who chose not to file claims are now precluded from obtaining compensation.
- The statutes of limitations have run since we filed.

Recommendation

- **There is nothing to lose, much to gain**

  Monitoring the strategy pursued by the lead plaintiffs represents no risk and no cost. In other words: "Pure Alpha".

  Monitoring underlying litigation should become standard practice for investors with significant losses.

Recommendation

- **It is easy (for you):**

List of required information:

- **the opening balance**: the number of shares held by each fund on the first day of the class period;
- **the closing balance**: the number of shares each fund held on the last day of the class period;
- **the transactions in between**:
  (i) the number of shares traded;
  (ii) whether those shares were bought or sold;
  (iii) the date of the transaction;
  (iv) the price of the traded shares;
  (v) the total cost or proceeds of each transaction; and
  (vi) the stock exchange on which the transaction took place.

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