Asia-Pacific | Europe | North America

Quant. Finance Discussion Paper

CEG calls attention to the rise in shareholder disputes

Introduction

During the past few years we have continued to see an increase in shareholders holding their boards and other shareholders to account. In this article CEG discusses some of the key shareholder dispute developments, where action by shareholders has varied from disagreement over corporate decisions, such as mergers and acquisitions, to disputes about the accuracy and completeness of a company's financial information. This activism of shareholders has been driven by many factors including the financial crisis, availability of funding through third-parties and changes to legislative and regulatory frameworks making it possible for such claims to be taken forward. This paper highlights the various incentives behind these actions and the range of outcomes, which have often benefitted from the use of experts to ensure a speedy and cost-effective resolution.

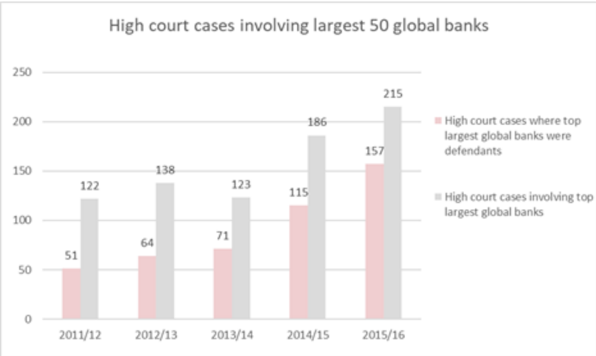
Trend in the rise of shareholder actions

In times of financial stress, uncertainty and poor performance we generally see an increase in shareholder disputes. This correlation was demonstrated spectacularly during the global financial crisis. While we saw a particularly difficult landscape for both group and shareholder action, there was also an increased incentive to litigate due to uncertainty and distress, causing financial institutions to behave abnormally. This period saw a marked rise in appetite for shareholder action, particularly from shareholders of financial institutions with investors challenging boardroom pay and funds pursuing claims for misleading financial statements in investee companies.

Many of the shareholder challenges arising from the financial crisis are "follow-on" from the actions of financial regulators. For example; the Australian regulator ASIC[i] has precedent for pursuing companies for civil penalties for failing to disclose information. This was demonstrated in 2016 when ASIC announced it would investigate whether Slater & Gorden (S&G) deliberately manipulated financial reports, particularly in relation to the performance of its UK legal service business, Quindell. The outcome of such an investigation will help the shareholder litigants of S&G establish whether there was adequate disclosure made by S&G about the true value of the Quindell assets in 2015.

US and European regulators have also carried out high-profile investigations into claims of manipulation of financial benchmarks by banks. The most publicised are the Libor and Forex fixings, resulting in reports of alleged market manipulation and billions of dollars in regulatory fines. This action by the financial regulators has subsequently opened the banks to private litigation from banking clients and those using the benchmarks set. In addition to this, competition regulators have also opened cases on Libor and Forex.[ii]

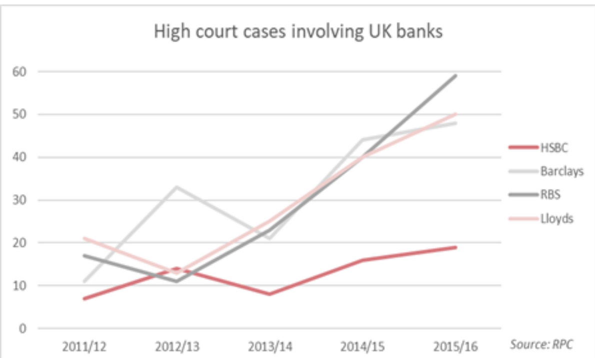
In fact, during the past few years, banks have regularly featured in the number of high profile cases. Law firm RPC has stated that over the last five years, the world's 50 largest banks have been involved in a total of 784 High Court cases and in 58% of those cases the banks have been the defendant.



Source: RPC

In this mix, UK banks have been prominent, with Royal Bank of Scotland (RBS) having the most number of cases (118). Many of the cases involving RBS have been well publicised and include:

- Class action litigation where shareholders claim they were misled over the financial health of the company prior to signing up for the rights issue in 2008.
- Allegation of interest rate swap mis-selling by Guardian Care Homes, linked to the manipulation of the Libor rate.
- Allegation by small businesses that the RBS Global Restructuring Group (GRG) were instrumental to the failure of their company.



Source: RPC

In addition to litigation driven by dishonest corporate behaviour, during the financial crisis there was an increase in disputable corporate decisions by boards, such as allegations of raising capital from the private sector without the full or accurate disclosure of the financial health of the company. Many of these global companies have not only majority corporate shareholders, whom traditionally challenge the company's decisions, but also many minority shareholders, the sum of which is often the largest percentage share. As a result, we have seen significant developments in the number of group or class action disputes.

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This rise in class actions has been facilitated by a dramatic increase of shareholder associations which enable the aggregation of claimants and share of dispute costs. In addition to this, the litigation market has seen an increase in insurance products and third-party funding, contributing to a growing trend of such actions over recent years.

While many smaller shareholder disputes have occurred following regulatory or competition investigations, there has also been a significant rise in small shareholders coming together to challenge board decisions. When Sir Philip Green tried to take over Marks and Spencer (M&S), with the support of the larger shareholders, the acquisition was defeated by the smaller shareholders at the AGM. This action by smaller shareholders has led to M&S forming a non-public shareholder panel offering investors a direct line to the boardroom.

Other companies have also followed suit, creating boards to improve the relationship between shareholders and the company to minimise future shareholder disputes. In July 2017, AkzoNobel announced at an Extraordinary General Meeting of shareholders (EGM) the formation of their supervisory board. This board formation was to address the considerable shareholder discontent following the rejection by the board of two unsolicited bids by PPG in March and April that year. The outright rejection of the bids was heavily criticised by many shareholders, with the majority shareholder, Elliot Advisors, taking court action. In this case, the Dutch courts ruled in favour of AkzoNobel and the chairman, but disagreement between the company and shareholder continued until a truce was called in August 2017, when AkzoNobel agreed to appoint three new directors to its board.

Not all calls for the creation of a shareholder liaison committee have been successful. One of the most recent and well publicised being that of RBS rejecting this demand from shareholders in 2016, citing legal grounds. This call for a shareholder committee was raised again in December 2017 and looks to be an issue that refuses to subside.

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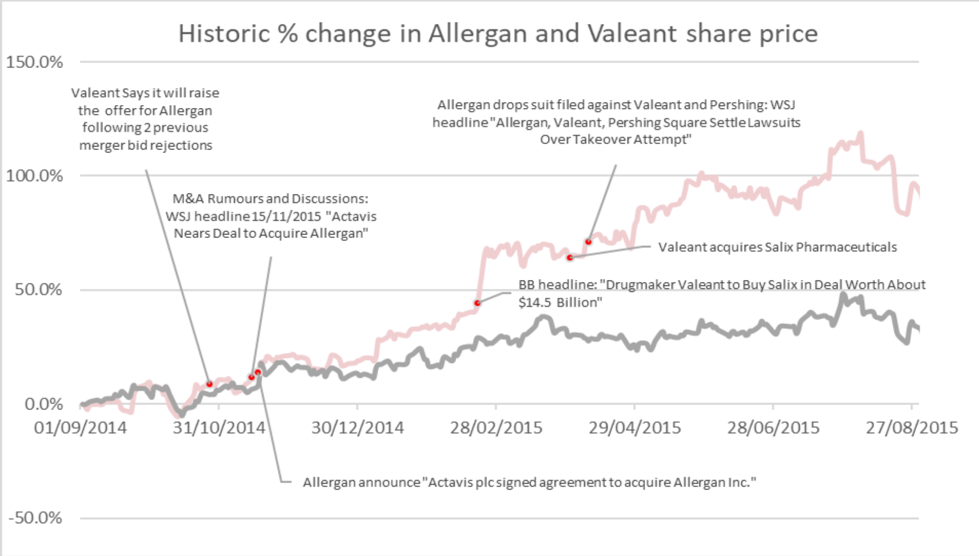
Frequently class actions follow the lead of a governance investigation or majority shareholder action and while the AkzoNobel shareholder dispute was led by Elliot Advisors, there was also support for this from other disgruntled shareholders. A more conclusive example of disputes initially led by majority shareholders but concluded by class actions occurred in October 2017, when Facebook was forced to retreat over its plan to create a new class of shares, following the threat of an investor lawsuit. This shareholder opposition started on May 2016 by AP7, a Swedish state pension fund, but later joined by other shareholders and the case became a class action. The lawsuit claimed that the company's proposed reclassification of shares would cost public shareholders $10bn by devaluation of the stock they held. The trial was scheduled to begin 22 September 2017, but settled prior to going to court.

Other increased shareholder activism has occurred from a significant rise in the number of shareholders looking for short-term gain. While there has always been those that look to make money on small market moves or merger arbitrage, a more recent growing trend is that of the "activist shareholder". That is, third-parties that buy positions in companies to challenge the running of that company or influence buy out activities. Over the years, several big money managers have specifically targeted firms where they feel they can take an active role in running the company for better returns. This could be argued to be a short-term investment strategy, putting companies increasingly under pressure to deliver short term gains at the expense of longer term stability, but there are also examples of companies benefitting from a more active, professional shareholder.

Currently there are more than 100 hedge funds engaged in frequent activism and more than 300 others that have launched activism campaigns in recent years. In fact, the scale of such activity has become such that in August 2016 at the International Business Council (IBC), Wachtell, Lipton, Rosen & Katz proposed the corporate governance framework, "New Paradigm". This is premised on the idea that corporations and institutional investors can forge a meaningful and successful private-sector solution. This may pre-empt a new wave of legislation and regulation such as adumbrated in the recent policy statement by Prime Minister Theresa May in the UK.[iii]

There are numerous interesting recent examples of shareholder activity from activist funds, but one that highlights the many features of this business is that of activist fund, Pershing Square and pharmaceutical company, Allergen. In April 2014, Pershing Square took a stake in Allergan and teamed up with Valeant Pharmaceuticals International to push for a merger deal between the two. However; in November 2014 Allergan merged with another pharma company, Actavis, after it agreed to pay a substantially higher price than was being offered by Valeant.



Source: Bloomberg data, CEG analysis

While this merger occurred between Allergen and another third-party, Pershing Square made $2.2 billion profit from the shares it held in Allergan and Valeant $389 million[iv], due to a prior profit share agreement with Pershing. In December 2014, following the Allergen/Actavis merger, a $2 billion class action lawsuit was brought against Pershing Square and Valeant by former investors in Allergan Inc.

Here, the plaintiffs alleged that the CEO of Pershing Square, Ackman, secretly acquired nearly 10% of Allergen's stock and committed those shares to support Valeant's bid. Not only was it suggested that this violated SEC regulation, but also that the acquisition of those shares was based on insider information of the hostile takeover bid that would send Allergan's stock soaring.

This lawsuit is still on-going, but according to its annual report, Pershing Square has set aside $75 million to cover c. 40% of the settlement, suggesting the defendants are hoping to settle for less than $200 million. However, this and other allegations of raising drug prices of companies acquired for short term profit are reflected strongly in the share price of Valiant.

Source: Bloomberg data, Business Insider and CEG analysis

While the shareholder disputes discussed range from the activity of majority shareholders to class actions, they have all occurred due to shareholders feeling aggrieved that certain actions have been unjustly detrimental to their investments.

"...in all these disputes the quantum of claim needs to be calculated and demonstrated."

The facts of a dispute can be relatively straight forward, such as when shareholders consider that they were not compensated at a fair market value following a merger or government intervention. Others are more complex, where market manipulation and insider trading is thought to have led to unfair treatment of other shareholders, or that the implementation of short-term strategies undermined long-term prospects of a company, activities particularly demonstrated by the activist investor. However, in all these disputes the quantum of claim needs to be established.

Engaging an expert to support a dispute is particularly important during the preliminary stages when it is critical to assess whether the claim is worth taking forward. Litigation is expensive in terms of time and money spent and the expected returns need to be positive. The quantification of damages requires the development of a theoretical and analytical framework, which typically poses may issues. These will be addressed more effectively by an expert with experience of similar cases. Quantum expertise is often an important part of showing liability. Along with a strong legal team, employing an expert who has industry expertise, as well as sufficient knowledge of valuation techniques and damage calculations, is critical to the success of a case. In tandem with the analysis, the expert will be able to present arguments from complex analysis in a format suitable for court proceedings – an expert report – and, if subsequently required, an expert testimony. Without an expert at hand, the critical analyses may not be performed, or they may not be presented in a manner appropriate for the courts.

Determining the quantum of claim

While many of the shareholder disputes discussed are "follow-on" damage actions succeeding regulatory investigations, the success of these claims remains dependent on the liability analysis presented. A key factor in the determination of liability is validation that the behaviour investigated by the regulator resulted in abnormal behaviour and losses to the claimant. This analysis to demonstrate and determine the quantum of damages is also a main driver in those shareholder disputes that do not follow on from regulatory findings. As such, ensuring that both the legal and financial analysis is clearly and accurately assessed is key to any shareholder claim.

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In order to demonstrate and determine the quantum, several economic and financial techniques can be employed. The precise method depends primarily on the type of dispute the claimant has and the decision on the most reasonable method, or methods, is key to building a robust argument. At this stage, access to expert witness, product and quantitative experience is highly beneficial.

In some cases, the expert could use counterfactual arguments, running quantitative or economic models under these scenarios to determine a fair market value and hence quantum. Another technique often used for demonstrating market behaviour or mis-selling is where the expert uses fundamental models and complex financial engineering, along with industry expertise, to analyse trading patterns or to run hedging simulations.

This quantitative analysis and crucially the clear presentation of the analysis should be a key part of the claimants' case. The analysis can help support the claim, as well as determine the quantum of claim. In addition to supporting the success of the case, clear analysis demonstrating unfair behaviour and related losses help to ensure a speedy resolution and avoid further litigation, both of which help to minimise legal costs and maximise benefit.

About CEG

CEG brings together senior professionals with experience in industry, consultancy and academia and the leading competition and regulatory agencies, to offer insightful and dependable advice.

Using up-to-date economic and finance theory and quantitative techniques, CEG experts prepare reports, provide input into client submissions, advise on case strategy, and provide testimony and presentations before government agencies, courts and arbitral tribunals across the globe. CEG's quantitative finance professionals not only assist such clients and their attorneys in such matters but can also advise regulatory and competitive authorities when conducting investigations.

Being independent and free from conflict allows us to be objective in providing our advice.

i Australian Securities and Investments Commission.
ii Focus of this note is on financial regulation.
iii Green Paper: Corporate Governance Reform, November 2016
iv As reported by New York Times

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