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The Disciplinary Effects of Proxy Contests

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Abstract. Using a manually collected data set of all proxy contests from 1994 through 2012, I show that proxy contests play an important role in hostile corporate governance. Target shareholders benefit from proxy contests: the average abnormal returns reach 6.5% around proxy contest announcements. Proxy contests that address firms' business strategies and undervaluation are most beneficial for shareholders. By contrast, proxy contests that aim at changing capital structure and governance do not lead to higher firm values. Relative to matching firms, future targets are smaller, they have higher stock liquidity, higher institutional and activist ownership, lower leverage and market valuation, and higher investments. Whereas most of these characteristics predict proxy contests in time series, prior to proxy contests, targets also experience poor stock performance, decreases in investments, increases in cash reserves and payouts to shareholders, and increases in management's entrenchment. These changes in corporate policies are consistent with targets' attempts to affect the probability of a proxy contest.

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Keywords: proxy contests • corporate governance • financial institutions

1. Introduction

The agency problem created by separation of ownership and control in publicly traded corporations with dispersed ownership is a central topic of the corporate governance literature, which focuses on mechanisms for disciplining incumbents. These mechanisms range from informal "jawboning" to contests for corporate control, which are used to change management and to obtain control in publicly traded corporations. In 1992, the regulatory burdens surrounding proxy contests were substantially liberalized, thus reducing the cost of engaging in a proxy contest. Specifically, the 1992 proxy reform reduced the costs of proxy contests by relaxing constraints on communications between shareholders of public corporations (Sharara and Hoke-Witherspoon 1993). As a result, the frequency of proxy contests increased significantly after 1992. The average number of proxy contests was 56 (68) per year during the years 1994–2012 (2006–2012) compared with an average of 17 a year during the years 1979–1994 (see Figure 1 and Mulherin and Poulsen 1998).

Whereas shareholders more often rely on the proxy contest mechanism, the evidence pertaining to the role of proxy contests in modern corporate governance is limited because most of the existing literature uses pre-1992 proxy reform data. Do proxy contests play an active governance role in the post-1992 period? This question has important policy implications for debates on the optimal scope of shareholder rights in public companies (Bebchuk 2007, Lipton and Savitt 2007). Whereas a conclusion that the proxy contest mechanism is beneficial provides support for strengthening shareholder rights in proxy contests, the opposite conclusion provides support for constraining them (Bebchuk and Weisbach 2010). The effort that the U.S. Securities and Exchange Commission (SEC), institutional investors, and business groups expended fighting for or against 2010 proxy access reform suggests that the effectiveness of the proxy contest mechanism is of central importance.[1]

This paper reveals several interesting empirical regularities. First, I show that proxy contests play an increasingly important role in hostile corporate governance. There were 1,061 proxy contests from 1994 through 2012. Whereas shareholders more frequently rely on proxy contests, hostile takeovers became less frequent, suggesting that there was a significant change in hostile corporate governance over the last three decades. The widespread adoption of antitakeover provisions, the enactment of state-level antitakeover laws favoring management, and the collapse of the junk bond market have increased the cost of hostile tender offers and therefore contributed to the decrease in frequency of such offers (Karpoff and Malatesta 1989, Bertrand and Mullainathan 2003, Cremers and Ferrell 2014). By contrast, the 1992 proxy reform, which allowed independent shareholders to freely engage in communication without being monitored by the SEC; the rise of activist hedge funds; and increased stock liquidity are among potential explanations for the increasing frequency of proxy contests.

Second, I document several key characteristics of proxy contests. I find that 81% of proxy contests are noncontrol contests. These are either short-slate contests or issue contests. The current corporate governance environment therefore resembles the "market for corporate influence" and not the "market for corporate control." When I analyze what types of shareholders stand behind proxy contests, I find that activist hedge funds are by far the most frequent proxy contest sponsors: 57% of proxy contests were sponsored by activist hedge funds. The number (proportion) of proxy contests sponsored by activist hedge funds increased from 162 (38%) from 1994 through 2002 to 440 (70%) from 2003 through 2012. Thus, activist hedge funds often materialize the threat of launching a proxy contest if the management is not willing to implement changes suggested by the activists (Brav et al. 2008). This result also fits well with the fact that most proxy contests are noncontrol contests because activist hedge funds seek not to run firms but to influence or replace existing management.

I find that about half (47%) of proxy contests are resolved through voting process and that there is substantial uncertainty about the voting outcome in these cases: dissidents' chances of failing or winning a voting contest are about 50%. The second most frequent outcome is a settlement agreement between firm management and dissident shareholders: 267 contests, corresponding to 25% of such events, were settled, often allowing dissident director nominees to join the board. Another important characteristic of a proxy contest involves the stated goals of dissident shareholders. Addressing undervaluation concerns is the first priority of dissident shareholders (41% of proxy contests). The second most frequently stated goal is corporate governance (39% of proxy contests). Dissidents also often address firms' business strategies and the possibility of selling the target company (28% and 27% of proxy contests, accordingly).

Third, when I study the valuation of implications of proxy contests, I find that dissidents are more likely to initiate a proxy contest after a period of poor stock performance: cumulative abnormal returns (CARs) during the two years that precede proxy contest announcements is −10%. Following proxy contest announcements, the average abnormal returns reach 6.5%, suggesting that target shareholders benefit from proxy contests. When I analyze cross-sectional variation in the valuation implications of proxy contests, I find that whereas the announcement effect is stronger when a proxy contest is initiated by activist hedge funds versus other types of dissidents, the CARs of two groups are similar eight months after the announcement, suggesting that the overall changes in stock prices are similar when these two groups of dissident shareholders are involved. Moreover, the analysis reveals interesting relations between the valuation of implications of proxy contests and dissidents' stated goals. I find that most of value creation for shareholders is concentrated in proxy contests that address business strategies and valuations of targets. There is almost no value creation for shareholders when governance, capital structure, and selling the target company are among dissidents' stated goals.

Fourth, I study what firm characteristics predict proxy contests. Probit analysis reveals that proxy contest targets in the postreform environment are suffering from low market valuation and poor stock performance, which dissidents typically use when they criticize incumbent management. Targets are also characterized by high institutional and activist ownership, which indicates a more sophisticated shareholder base, whose support dissident shareholders often need to succeed with a proxy contest. Moreover, a company is more likely to be targeted in a proxy contest if it has a smaller market cap, which is consistent with the notion that it is more expensive to launch a proxy contest in a large company. As far as corporate policies are concerned, targets are characterized by lower investments and higher dividend payout ratios. Interestingly, the evidence indicates that stock liquidity positively affects the likelihood of a proxy contest. This result finds support in the theoretical literature, which suggests that greater stock liquidity makes it easier for investors to accumulate large stakes without substantially affecting the stock price and therefore facilitates shareholder activism (Kyle and Vila 1991, Bolton and von Thadden 1998, Maug 1998, Collin-Dufresne and Fos 2014).

To understand what firm characteristics predict proxy contests in cross section, I compare future targets and match nontargets, identified based on year, industry (three-digit Standard Industrial Classification (SIC) code), market cap, and book-to-market ratio. I find that future targets are smaller than matched nontargets, and they have lower market valuation, lower leverage, higher activist ownership, and higher stock liquidity. Moreover, future targets invest more than matched nontargets, suggesting that targets suffer from overinvestment problem. Whereas most of these characteristics predict proxy contests in time series, prior to proxy contests, targets also experience poor stock performance, decreases in investments, increases in cash reserves and payouts to shareholders, and increases in management entrenchment.

The evidence pertaining to dissidents' stated goals and firm characteristics reveals that firms can take concrete steps to reduce the probability of a proxy contest. To address this possibility, I examine whether companies change their financial policies when the likelihood of a proxy contest increases. Consistently with this conjecture, I find that when the likelihood of a proxy contest increases, companies increase leverage

and payouts while also decreasing cash reserves and investments. Although this relation is suggestive, one needs to find an instrument for the likelihood of a proxy contest to show that the relation is also causal. This relation does suggest, however, that the proxy contest mechanism plays a disciplinary role. That is, companies change corporate policies when the mere threat of a proxy contest increases.

This paper contributes to several strands in the broader finance literature. First, the paper contributes to the corporate governance literature on proxy contests. Most of the existing literature studies proxy contests that took place prior to the 1992 proxy reform (Dodd and Warner 1983, DeAngelo and DeAngelo 1989, Ikenberry and Lakonishok 1993, Mulherin and Poulsen 1998). This paper, therefore, is the first to provide comprehensive evidence pertaining to the role of proxy contests in the post-1992 proxy reform period.[2] The paper shows that substantial changes in types of proxy contests took place over the past three decades. For example, activist hedge funds became the most frequent type of proxy contest sponsors. Moreover, most proxy contests aim not at controlling the board but at electing a few dissident shareholders' nominees to represent shareholders' interests on the board of directors.

Second, the evidence documented in this paper suggests the occurrence of a substitution of proxy contests for hostile takeovers. Whereas it has been documented that hostile takeovers have played a significant disciplinary role, several changes in the regulatory environment and the structure of financial markets have decreased the disciplinary effects of hostile takeovers (Bertrand and Mullainathan 2003). As this paper shows, consequent changes in the regulatory environment led to a significant increase in the disciplinary effects of proxy contests.

Third, this paper contributes to the literature that studies the valuation implications of proxy contests (e.g., Dodd and Warner 1983, DeAngelo and DeAngelo 1989, Ikenberry and Lakonishok 1993, Mulherin and Poulsen 1998). I find that, consistent with most existing studies, target shareholders benefit from proxy contests. Interestingly, the overall changes in stock prices are similar when proxy contests sponsored by activist hedge funds are compared with other proxy contests. The paper also contributes to the literature by showing that the valuation of the implications of proxy contests depend to a great extent on dissidents' stated goals.

Finally, the paper contributes to the literature that studies firm characteristics of proxy contests and of proxy contest targets. I document a substantial change in the composition of proxy contest sponsors during the sample period: activist hedge funds became the dominant class of proxy contest sponsors during this period. Also, this paper is the first to analyze factors that predict proxy contests in cross section and in time series.

The rest of the paper is organized as follows. The institutional background and description of the data are introduced in §2. Section 3 presents characteristics of proxy contests, such as contest type, dissident type, dissidents' stated goals, and contest outcomes. Section 4 analyzes the valuation implications of proxy contests. Cross-sectional and time-series factors that predict proxy contests are described in §5. The relation between corporate policies and the likelihood of a proxy contest is reported in §6. Section 7 concludes.

2. Institutional Background and Sample Description

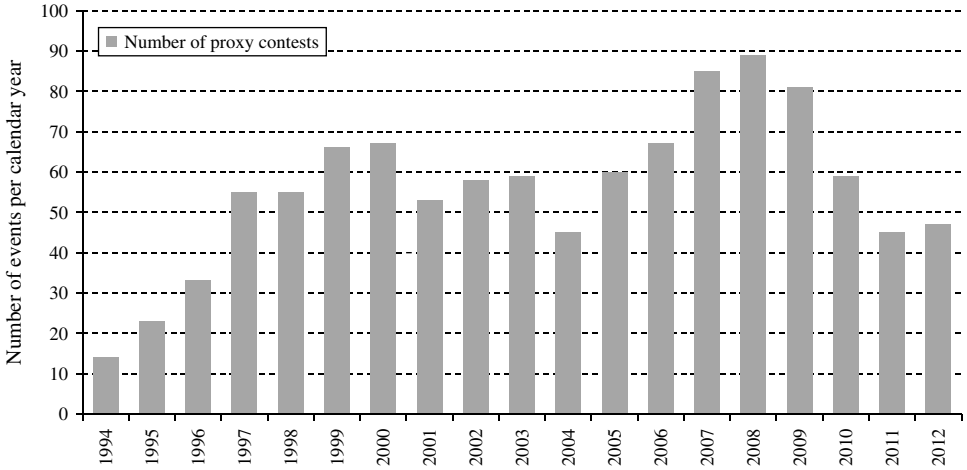
During a proxy contest, dissidents and incumbents forward proxy solicitation materials to shareholders, who sign and return the proxy form indicating their preferred group. The agents for each group accumulate votes via the returned proxies and cast these votes at the shareholders' meeting. This process is known as the contested solicitation of votes. The SEC has Congress's authorization to regulate proxy solicitations.

The sample of companies targeted by proxy contests (hereafter, targets) is constructed as follows. In the incident of a contested solicitation of votes, the following forms are submitted to the SEC through EDGAR: a preliminary proxy statement in connection with contested solicitations (PREC14A) and a definitive proxy statement in connection with contested solicitations (DEFC14A). I use submissions of these forms to identify proxy contest events.[3] First, I identify more than 6,000 filings of either PREC14A or DEFC14A forms using an automatic searching script, which checks the existence of either PREC14A or DEFC14A forms in EDGAR for each company in the Compustat universe from 1994 through 2012. This method identifies *all* contested solicitations of votes in the universe of Compustat companies. Next, I manually check the filings and identify proxy contest events from 1994 through 2012. There are about six filings of either PREC14A or DEFC14A forms during an average proxy contest. The final sample is the universe of all proxy contests from 1994 through 2012 and consists of 1,061 unique proxy contests.[4]

Figure 1 presents the time distribution of proxy contests during the sample period, showing that, on average, 56 proxy contests take place each year. The last comprehensive study of proxy contests, by Mulherin and Poulsen (1998), documents that the average number of proxy contests was 17 per year from 1979 through 1994. Thus, shareholders rely on proxy contests more frequently when they want to influence corporate governance.

One potential explanation of the increasing frequency of proxy contests is the 1992 proxy reform.

Figure 1. Time Distribution of Proxy Contests



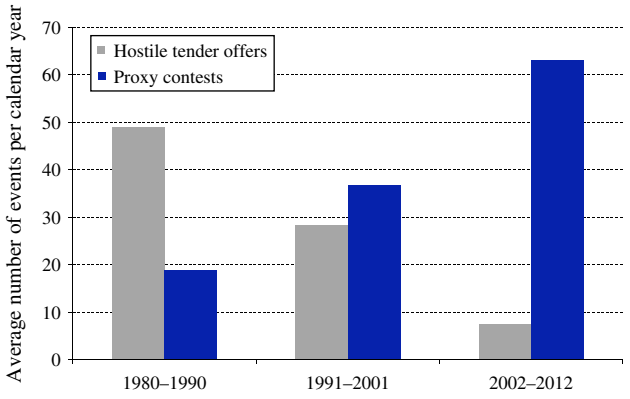
Notes. The bars plot the number of proxy contests initiated each year. The proxy contest data are described in §2.

During the early 1990s, regulators felt a sense of urgency regarding the proxy rules because of the perceived entrenchment of management, brought about by three events. First, many firms adopted stringent antitakeover defenses (e.g., poison pills). Second, by 1991, 40 states had enacted antitakeover statutes. Third, the collapse of the junk bond market destroyed the major financing mechanism used to fund corporate takeovers. In 1992, the SEC introduced a proxy reform measure. The reform substantially liberalized the regulatory burdens applying to proxy contests and thus reduced the cost of engaging in a proxy contest. Specifically, the 1992 proxy reform reduced the costs of proxy contests by relaxing constraints on communications between shareholders of public corporations (Sharara and Hoke-Witherspoon 1993). Following the reform, shareholders could contact each other directly to discuss matters relating to the target company. Among additional factors that contributed to the increased frequency of proxy contests are the rise of activist hedge funds and an increase in stock market liquidity.[5]

Figure 2 presents the time distribution of proxy contests and hostile tender offers from 1981 through 2012. Figure 2 indicates a significant change in corporate governance over the last three decades: in the 1980s, dissident shareholders more often relied on hostile tender offers, whereas during the last decade, they relied almost exclusively on proxy contests. As discussed above, the widespread adoption of antitakeover provisions, the enactment of state-level antitakeover laws favoring management, and the collapse of the junk bond market have increased the cost of hostile tender offers and therefore contributed to the decrease in frequency of such offers (Karpoff and Malatesta 1989, Bertrand and Mullainathan 2003, Cremers and Ferrell 2014). By contrast, the 1992 proxy reform, which allowed independent shareholders to freely engage in communication without being monitored by the SEC, is one potential explanation of the increasing frequency of proxy contests. This study is therefore the first comprehensive study of proxy contests that took place after the 1992 proxy reform.

Additional data are compiled from several sources. Firm-level accounting information comes from Compustat. Stock returns come from the Center for Research in Security Prices. Institutional Common Stock Holdings come from Thomson Reuters Institutional Holdings Database. Corporate governance data on shareholder proposals and the Governance Index (GINDEX) come from RiskMetrics. Table 1 describes the variables used in the paper.

Figure 2. (Color online) Rise in Proxy Contests and Disappearance of Hostile Tender Offers



Notes. The dark bars plot the average number of proxy contests initiated each year during four sample periods. The gray bars plot the average number of hostile tender offers initiated each year. The proxy contest data are described in §2. The hostile tender offer data are from SDC database.

Table 1. Variable Definitions

Variable	Definition
BM	The ratio of the book value of equity to the market value of equity.
CASH	The ratio of total cash and cash equivalents to total assets.
DIVIDENDS	Dividend payout ratio, defined as the ratio of total dividend payments to net income before extraordinary items.
DIV. INITIATIONS	A dummy variable equal to 1 if the firm initiates dividend payments.
GINDEX	The Gompers et al. (2003) Governance Index.
ILLIQUIDITY	The Amihud (2002) illiquidity measure, defined as the yearly average (using daily data) of $1{,}000\sqrt{\frac{\lvert Return\rvert}{Dollar\ Trading\ Volume}}$.
INST	The proportion of shares held by institutions.
INST-AHF	The proportion of shares held by activist hedge funds.
INVESTMENT	Research and development expense and capital expenditures less the sale of property, plant, and equipment, divided by mean total assets, where the mean of total assets is the average of current and lagged total assets.
LEVERAGE	The net book leverage ratio defined as (book value of debt − cash)/(book value of debt + book value of equity).
MV	Market capitalization in millions of 1980 dollars.
REPURCHASES	The ratio of net repurchases (see Footnote 7 in Skinner 2008 for further details) to income before extraordinary items.
ROA	Return on assets, defined as earnings before interest, taxes, depreciation, and amortization divided by lagged total assets.
STOCK RETURN	The 12-month buy-and-hold return.

3. Characteristics of Proxy Contests

3.1. Types of Proxy Contests

There are three main types of proxy contests: control contests, short-slate contests, and issue contests. Control contests are filed by shareholders who want to gain control over a firm's board. Short-slate contests are targeted to obtaining a few noncontrolling seats on a board. Whereas control contests and short-slate contests both involve contested elections of directors, issue contests do not involve the election of a firm's board of directors. Issue contests either raise issues about a company's corporate governance or are related to proposals that are excluded by management from the proxy statement.[6]

The classification of proxy contests into three types was based on information taken from dissidents' proxy statements. I next present an example of each proxy contest type.

The proxy contest between a group of shareholders of Weis Markets, Inc., and the company's board of directors is an example of a control contest. In 1999, Weis Markets was targeted by a group of shareholders who sought to remove the entire board of directors of the company and to elect nominees recommended by the group. The group asked shareholders to vote to reconstitute the board of directors "to better reflect the shareholder base of Weis Markets, and to approve certain resolutions and amendments to the By-Laws designed to allow the shareholders to continue to have a meaningful opportunity to influence the management of Weis Markets."[7] Members of the group beneficially owned approximately 41% of Weis Markets stock, and directors and officers as a group owned approximately 47%. After the board of directors had authorized its financial advisor to conduct a full review of all options available to the company, including a possible sale or recapitalization of the company, the group of dissident shareholders agreed to withdraw its request for a special meeting and therefore terminated the proxy contest.

Short-slate contests are targeted to obtaining a few noncontrolling seats on a board. For example, two former executives of Insituform Technologies, Inc., sought to elect four directors to Insituform's 13-member board. To do so, a committee was formed to restore value to Insituform Technologies. The committee was formed "because of their desire to see the value of Insituform maximized for all of the Company's stockholders, and their concerns that a number of the Company's existing directors do not support the Company's existing strategic direction and are influenced by conflicts of interest."[8] On July 3, 1997, the company and the group of dissident shareholders announced that they had reached an agreement in principle to settle a dispute over the composition of the company's board of directors. The company agreed to reduce the board from 13 to 9 members, eliminate the staggered terms of directors, and add two new independent directors to the board. One of the new independent directors joining the board was a member of the group of dissident shareholders.

Whereas control contests and short-slate contests both involve contested elections of directors, issue contests do not involve the election of a firm's board of directors. Issue contests either raise issues about the company's corporate governance or are related to proposals that are excluded by management from the proxy statement. For example, in 2001, two shareholders of Biopool International, Inc., R. Gale Daniel and Larry C. Fenster, asked shareholders to vote against two proposals recommended by Biopool's board. Specifically, Daniel and Fenster recommended voting against two items: (1) amending Biopool's certificate of incorporation to limit certain actions by stockholders and (2) authorizing the issuance of preferred stock.[9] Dissident shareholders succeeded, and these proposals did not receive a sufficient number of votes: approximately 21% of shareholders supported

Table 2. Types of Proxy Contests

Proxy contest type	Number of events (1)	Frequency (%) (2)
Control contests	199	19
Noncontrol contests:		
Short-slate contests	398	39
Issue contests	120	12
Short-slate and issue contests	310	30
Subtotal noncontrol contests	828	81
Total	1,027	100

Notes. This table presents the study's classification of proxy contests into three types: short-slate contests, issue contests, and control contests. Control contests are filed by shareholders who want to gain control over board. Short-slate contests are targeted to obtaining a few noncontrolling seats on board. Issue contests do not involve elections of a firm's board of directors. They either raise issues about the company's corporate governance or are related to proposals that are excluded by management from the proxy statement. The sample period is 1994–2012.

the first proposal, and 35% of shareholders supported the second proposal.

Table 2 presents the distribution of proxy contest types in the 1994–2012 sample. Of the proxy contests, 19% are control contests and 81% are noncontrol contests. The evidence suggests that proxy contests that became more frequent after the 1992 proxy reform are not control contests. Instead, these are mostly short-slate contests, often combined with issue contests. Since dissident shareholders rarely seek control over a target's board, the current corporate governance environment resembles the market for corporate influence and not the market for corporate control.

3.2. Sponsors of Proxy Contests

In this section I describe which types of shareholders stand behind proxy contests. I consider five types of dissident shareholders: activist hedge funds, corporations, pension funds, prior insiders and employees, and groups of shareholders.[10] Table 3 presents the distribution of contests sponsors in the full sample (1994–2012), from 1994 through 2002 and from 2003 through 2012.

Activist hedge funds are by far the most frequent proxy contest sponsors: 57% of proxy contests were sponsored by activist hedge funds. The number (proportion) of proxy contests sponsored by activist hedge funds increased from 162 (38%) from 1994 through 2002 to 440 (70%) from 2003 through 2012, corresponding to a 170% increase in the number of proxy contests sponsored by activist hedge funds. Thus, activist hedge funds often materialize the threat of launching a proxy contest if management is not willing to implement changes suggested by the activists (Brav et al. 2008).

Other types of proxy contest sponsors became less frequent during the sample period. The percentage of proxy contests sponsored by corporations, prior insiders and employees, and groups of shareholders declined significantly during the sample period. For example, the number (proportion) of proxy contests sponsored by corporations decreased from 87 (20%) from 1994 through 2002 to 34 (5%) from 2003 through 2012. Because corporations often sponsor contests that involve changing the controlling shareholder, this result is consistent with the downward trend in the frequency of hostile tender offers. Finally, note that although pension funds own a significant share of common stock and often sponsor regular (noncontested) shareholder proposals, they rarely sponsor proxy contests. Over the sample period, only two proxy contests were sponsored by pension funds.

Overall, the evidence indicates that activist hedge funds constitute by far the most active class of dissident shareholders. This result fits well with the evidence on proxy contest types: most proxy contests are noncontrol contests because hedge funds seek not to run firms but to influence or replace the existing management.

Table 3. Sponsors of Proxy Contests

	Full sample		1994–2002		2003–2012		Difference (%)	*p*-Value
Sponsor type	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Activist hedge funds	602	57%	162	38%	440	70%	32***	0.0000
Corporations	121	11%	87	20%	34	5%	−15***	0.0000
Pension funds	2	0%	2	0%	0	0%	0	1.0000
Prior insiders and employees	120	11%	66	15%	54	9%	−6***	0.0032
Group of shareholders	213	20%	109	26%	104	16%	−10***	0.0001
Total	1,058		426		632			

Notes. This table presents the study's classification of proxy contests into sponsor classes. The sample period is 1994–2012. Columns (1) and (2) report the frequency and proportion of contests for each sponsor type in the full sample. Columns (3) and (4) report the frequency and proportion of contests for each sponsor type from 1994 through 2002. Columns (5) and (6) report the frequency and proportion of contests for each sponsor type from 2003 through 2012. Column (7) reports the differences between the results shown in columns (6) and (4). Column (8) reports *p*-value of the differences.

*** indicates statistical significance at the 1% level.

3.3. Outcomes of Proxy Contests

Proxy contests can be resolved in four main ways: (1) a voting process, (2) a settlement agreement between management and dissident shareholders, (3) the withdrawal of proxy solicitations by dissidents, and (4) delisting or taking over a target firm. Table 4 presents the distribution of proxy contest outcomes.

I find that about half (47%) of proxy contests are resolved through a voting process. In voted contests, shareholders determine who is going to win the contest by casting their votes in favor of either management or the dissident group. Out of 503 voted contests, in 274 cases dissident shareholders were able to achieve at least one of their formal goals (obtaining board seats or passing proposals). In 229 contests, dissident shareholders failed to achieve any of their formal goals, implying that in about 55% of voted contests dissidents at least partially succeed. Thus, there is substantial uncertainty about the outcomes of voted contests: conditional on reaching the voting stage, dissidents' chances of failing or winning a proxy contest are about 50%.

The second most frequent outcome is a settlement agreement between firm management and dissident shareholders: 267 contests, corresponding to 25% of events, were settled. When entering into settlement agreements, dissident shareholders agree to terminate the proxy solicitation process and in return obtain concessions from management. These concessions often allow dissident director nominees to join a board.

The third most frequent outcome is withdrawal of dissident shareholders from the proxy solicitation process: dissidents took this step in 158 contests, corresponding to 15% of events. Whereas dissidents rarely state a formal reason for such a withdrawal, it is likely that when the withdrawal decision is made dissidents believe that their chances of winning a contest are very low.

Table 4. Outcomes of Proxy Contests

Outcome type	Number of events (1)	Frequency (%) (2)
Voted contests		
Voted contests—Dissidents win	274	26
Voted contests—Dissidents lose	229	21
Subtotal voted contests	503	47
Nonvoted contests		
Settled contests	267	25
Withdrawn contests	158	15
Firm delisted or taken over	60	6
Other	78	7
Subtotal nonvoted contests	563	53
Total	1,066	100

Notes. This table presents the study's classification of proxy contests into outcome groups. The sample period is 1994–2012.

Overall, the results reveal that dissident shareholders achieve their formal goals in about 50% of proxy contests. They do so by either entering a settlement agreement with a firm's management (25% of proxy contests) or winning the voted contest (26% of proxy contests).

3.4. Stated Goals of Dissident Shareholders

It is important to differentiate between what dissident shareholders can formally achieve by running a proxy contest (e.g., to elect a director or to pass a proposal) and their stated goals. In this section I describe the stated goals of dissident shareholders. I categorize the stated goals into the following five (not mutually exclusive) groups: (1) general undervaluation and maximizing shareholder value, (2) corporate governance, (3) change in business strategy, (4) selling a target company, and (5) change in capital structure (e.g., increasing payouts to shareholders). This classification of activists' stated goals closely follows Brav et al. (2008).

Table 5 presents the results. Addressing undervaluation concerns is the first priority of dissident shareholders. For instance, in 41% of proxy contests dissidents indicate that the main reason for running proxy contests is to address the general undervaluation of the target. In these cases the interests of dissident shareholders are clearly aligned with the interests of all nonincumbent shareholders.

The second most frequently stated goal is corporate governance: in 39% of proxy contests, dissidents want to make an impact on governance. For example, dissident shareholders often want to enhance board independence by electing their nominees. As the analysis in §3.3 indicates, dissident shareholders are often successful in achieving these goals.

The next two most frequently stated goals are business strategy and sale of a target company. As far as the business strategy goal is concerned, dissident shareholders often criticize the lack of focus in an investment strategy. When dissidents indicate that management

Table 5. Stated Goals

Goal type	Number of events (1)	Frequency (%) (2)
General undervaluation/ Maximize shareholder value	416	41
Governance	389	39
Business strategy	278	28
Sale of target company	270	27
Capital structure	132	13
Total	1,004	100

Notes. This table presents stated (not mutually exclusive) goals of dissident shareholders. The sample period is 1994–2011.

should consider selling a target company, they often indicate that management should contact an investment bank to facilitate that process. Dissident shareholders aim to achieve these goals in 28% and 27% of proxy contests, respectively.

Finally, in 13% of proxy contests, sponsors advocate for significant changes in a firm's capital structure. These changes include requests to increase leverage and to increase cash payouts through share repurchases and stock dividends.

Overall, dissidents' stated goals indicate that they pursue goals that are consistent with classical agency problems: undervaluation, lack of focus, low leverage, and insufficient payouts leading to high cash reserves.

4. Do Proxy Contests Create Value?

In this section, I ask the key question regarding the well-being of target shareholders: Do proxy contests create value? To address this question, I calculate the cumulative abnormal returns from the four-factor (market, size, book-to-market, and momentum) model from 24 months before the announcement of a proxy contest to 24 months after. Figure 3 reports full-sample CARs.

The evidence shows that activist shareholders are more likely to initiate a proxy contest after a period of poor stock performance. Cumulative abnormal returns drop below −10% two months prior to the proxy contest announcement. The sharp decline in valuation begins about a year before the proxy contest announcement.

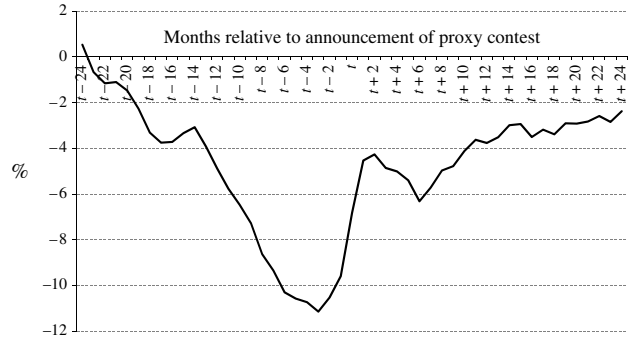
How do shareholders respond to proxy contest announcements? The period from one month before to one month after an announcement is characterized by strong stock performance: CAR increases by more than 6.5% during that period. The sharp increase in stock prices indicates that shareholders respond favorably to dissidents' decision to initiate a proxy contest (without long-term reversal). This result is consistent with findings in the literature that document a positive stock market reaction to shareholder activism (e.g., Brav et al. 2008, Collin-Dufresne and Fos 2015).

Does CAR depend on whether the dissident shareholder is an activist hedge fund? This question is interesting because activist hedge funds are often criticized for promoting short-term goals at the expense of long-term value. To address this question, Figure 4 reports CARs for the subsample of proxy contests sponsored by activist hedge funds (dark line) and the subsample of proxy contests sponsored by other types of dissidents (gray line). The evidence reveals that the overall changes in stock prices are similar when these two groups of dissident shareholders are involved. Whereas the announcement effect is stronger when a proxy contest is initiated by activist hedge funds, CARs converge eight months after the announcement. Thus, activist hedge funds are as productive as other types of dissident shareholders in creating value.

Next, I analyze how CARs vary with the stated goals of dissident shareholders. In each panel of Figure 5, the dark (gray) line plots CARs for the subsample of proxy contests where a specific goal is (is not) among dissidents' stated goals (−13% versus −7%). Panel A shows that dissidents are more likely to address undervaluation following a sharper decline in stock prices. Interestingly, stock price appreciations following proxy contest announcements are *smaller* when dissidents address undervaluation, resulting in a lower firm value 24 months after an announcement. Thus, whereas addressing undervaluation is consistent with targets' past performance, it is followed by smaller improvements in firm value.

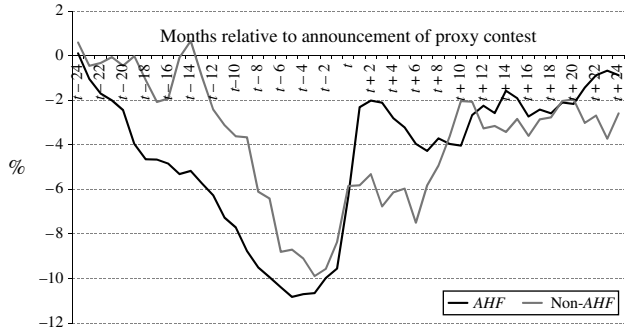
Panel B reveals that upon the announcement of a proxy contest target stock prices appreciate most when dissidents aim at selling a target company (10% relative to 6.5% in the full sample). These announcements

Figure 3. Cumulative Abnormal Returns Around Proxy Contests



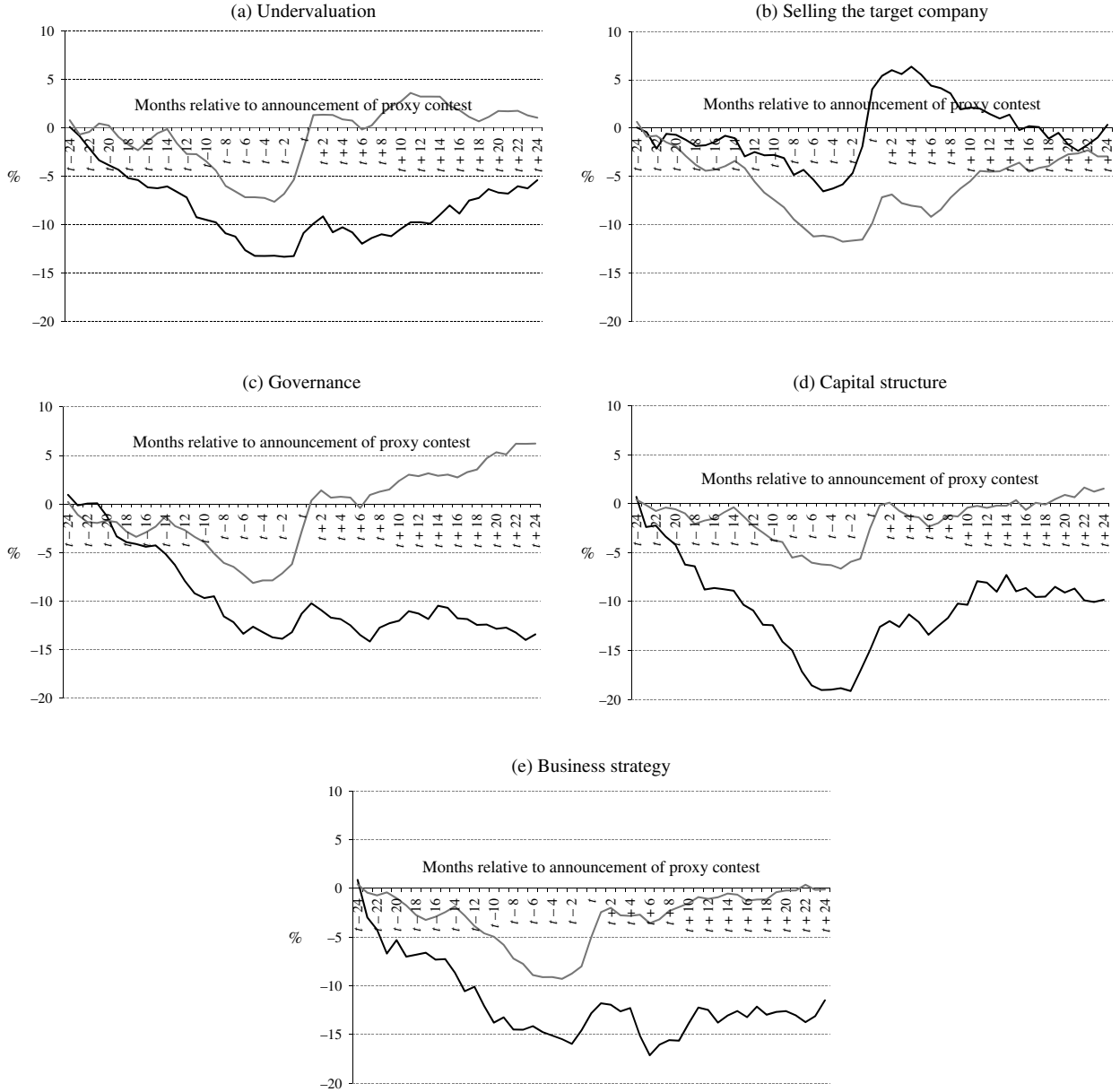
Note. This chart plots the cumulative abnormal returns from the four-factor (market, size, book-to-market, and momentum) model from 24 months before the announcement of a proxy contest to 24 months after.

Figure 4. Cumulative Abnormal Returns Around Proxy Contests: Does Sponsor Type Matter?



Notes. This chart plots the cumulative abnormal returns from the four-factor (market, size, book-to-market, and momentum) model from 24 months before the announcement of a proxy contest to 24 months after. The dark (gray) line plots CARs for the subsample of proxy contests sponsored by activist hedge funds (other types of dissidents).

Figure 5. Cumulative Abnormal Returns Around Proxy Contests: Does the Stated Goal Matter?



Notes. This chart plots the cumulative abnormal returns from the four-factor (market, size, book-to-market, and momentum) model from 24 months before the announcement of a proxy contest to 24 months after. In each panel, the dark (gray) line plots CARs for the subsample of proxy contests where a specific goal is (is not) among dissidents' stated goals. In panel A the stated goal is undervaluation. In panel B the stated goal is selling the target company. In panel C the stated goal is governance. In panel D the stated goal is changing capital structure. In panel E the stated goal is changing business strategy.

arrive after relatively small negative CARs during the preannouncement period (−5% relative to −10% in the full sample). Interestingly, postannouncement CARs behave quite differently depending on whether selling the target was among dissidents' goals: when dissidents state (do not state) it as a formal goal, the postannouncement CAR exhibits a negative (positive) drift. These two groups of proxy contest targets end up with similar firm value 24 months after the announcement.

Panels C and D show that preannouncement CARs are smaller when dissidents address governance and capital structure relative to the full-sample results (−15% versus −10%). Surprisingly, these two cases exhibit quite small stock price appreciations upon the announcement of a proxy contest. Probably most surprisingly, there are no long-term stock price appreciations in these cases. Thus, when governance and capital structure are among dissidents' stated goals, shareholders typically do not benefit from proxy contests.

Finally, panel E reveals that proxy contests, in which changing business strategy is among the stated goals, are announced after the sharpest deterioration in stock

prices: preannouncement CARs reach −20% and are four times as large as CARs for proxy contests when changing business strategy is not among the stated goals. Moreover, when dissidents address the business strategies of target companies, the long-term value creation for shareholders is high: CARs increase from −20% before an announcement to −10% 24 months after the announcement.

Overall, Figure 5 indicates that most value creation for shareholders is concentrated in proxy contests that address business strategies and valuations of targets. There is almost no value creation for shareholders when governance, capital structure, and selling a target company are among dissidents' stated goals.

5. What Predicts Proxy Contests?

In this section I examine how the characteristics of targets correlate with the likelihood of a proxy contest. To begin the analysis, I use probit regressions to estimate the partial effects of several covariates on the likelihood of a proxy contest:

$$\Pr(PC_{it} = 1) = \Phi(X_{it}\alpha_{21} + \zeta_t + \varepsilon_{it}), \quad (1)$$

where the dependent variable PC_{it} is a dummy variable equal to 1 if the company is targeted in a proxy contest during the year, Φ is the cumulative normal distribution, X_{it} is a vector of lagged covariates, and ζ_t are time fixed effects. These regressions cover all Compustat firm-year observations from 1994 through 2012, and they include both event and nonevent observations. All independent variables are defined in Table 1. Results are reported in Table 6.

Potential proxy contest targets are seen to suffer from low market valuation (higher *BM*) and poor stock performance (lower *STOCK RETURN*), which dissidents usually use when they criticize incumbent management. As evidence reported in §3.4 indicates, in 41% of proxy contests, dissidents indicate that the main reason for running the proxy contests is to reduce the general undervaluation of the target. For example, while criticizing the incumbent board in a proxy statement, dissident shareholders of Insituform Technologies, Inc., wrote, "In the past, we believe the incumbent Board has promoted poorly-conceived business strategies that resulted in a material decline in the value of Insituform common stock. Since 1991, the S&P 500 Index has gone up 100% while Insituform stock has gone down 63%."[11]

Potential targets are also characterized by high institutional ownership (higher *INST*), which indicates a more sophisticated shareholder base, whose support dissident shareholders often need to succeed with a proxy contest. Results reported in §3.2 reveal that activist hedge funds often sponsor proxy contests. Moreover, it is plausible that activist hedge funds are more likely to support dissident shareholders during a proxy contest. In accordance with that result, targets are characterized by high activist ownership (higher *INST-AHF*). Results pertaining to activist ownership are consistent with the theoretical analysis in Fos and Kahn (2015). The authors develop a model in which the presence of activist shareholders is one of the key factors that determine what type of corporate governance (exit or intervention) disciplines a manager. In their model, intervention is the equilibrium form of governance when a significant share of common stock is owned by activist investors.

A company is more likely to be targeted in a proxy contest if it has a smaller market cap (lower *MV*), which is consistent with the notion that it is more expensive to launch a proxy contest in a large company. As far as corporate policies are concerned, potential targets are characterized by lower investment (lower *INVESTMENT*) and a higher dividend payout ratio (*DIVIDENDS*).

The evidence indicates that stock liquidity positively affects the likelihood of a proxy contest. The Amihud measure of stock illiquidity has a large APE on

Table 6. Probit Analysis of Proxy Contests

Dependent variable: Dummy (of proxy contest)	(1) Coefficient	(2) APE	(3) *t*-stat
BM	0.0735**	0.0013	2.44
CASH	0.1294	0.0005	1.18
DIVIDENDS	0.1273**	0.0011	2.09
DIV. INITIATIONS	0.1394	0.0003	1.26
ILLIQUIDITY	−0.0944**	−0.0013	−2.23
INST	0.2414**	0.0013	2.22
INST-AHF	1.9592***	0.0017	8.27
INVESTMENT	−0.1877*	−0.0008	−1.91
LEVERAGE	0.0724	0.0004	0.55
MV (log)	−0.0409*	−0.0019	−1.73
REPURCHASES	−0.1081	−0.0005	−0.91
ROA	0.0647	0.0007	0.57
STOCK RETURN	−1.9746***	−0.0019	−4.29
Constant	−2.7518***		−16.14
Year dummies	Yes		
Observations	58,405		
Pseudo R^2 (%)	4.87		

Notes. This table reports estimates of the probit regression: $\Pr(PC_{it} = 1) = \Phi(X_{it}\alpha_{21} + \zeta_t + \varepsilon_{it})$, where the dependent variable PC_{it} is a dummy variable equal to 1 if the company is targeted in a proxy contest during the year, Φ is the cumulative normal distribution, X_{it} is a vector of lagged covariates, and ζ_t are time fixed effects. These regressions cover all Compustat firm-year observations from 1994 through 2012, and they include both event and nonevent observations. All independent variables are defined in Table 1. Column (1) reports probit coefficients. Column (2) reports the average partial effects (APEs). The APE corresponds to the change in the likelihood of a proxy contest as a result of a standard deviation change of a covariate. Column (3) reports *t*-statistics, calculated using heteroscedasticity robust standard errors and within correlation clustered by industry (three-digit SIC code).

*, **, and *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

the likelihood of a proxy contest. In particular, a one-standard-deviation increase in stock liquidity leads to an increase of 0.13% in the likelihood of a proxy contest in the full sample. Since the unconditional likelihood of a proxy contest is 0.55% in the full sample, the APE effect of stock liquidity is of considerable economic significance. This result finds support in the theoretical literature, which suggests that greater stock liquidity makes it easier for investors to accumulate large stakes without substantially affecting the stock price and therefore facilitates shareholder activism (Kyle and Vila 1991, Bolton and von Thadden 1998, Maug 1998, Collin-Dufresne and Fos 2014). The evidence is also consistent with Collin-Dufresne and Fos (2015), who show that activist shareholders who often engage in proxy contests significantly benefit from stock liquidity when they purchase a stake in a target company.[12]

Probit analysis suggests that several firm characteristics are correlated with the likelihood of a proxy contest. Therefore, probit analysis pools cross-sectional and time-series forces that predict proxy contests. To shed further light on that issue, I next analyze what firm characteristics are correlated with the likelihood of a proxy contest in cross section and in time series.

5.1. What Predicts Proxy Contests in Cross Section?

To begin the analysis of cross-sectional predictors of proxy contests, I compare characteristics of future proxy contest targets (during the period that ends one year before the event) and those of nontargets. Each firm characteristic is first aggregated at the firm level by taking the average over a period of years that precede the event for targets and by taking the average over the sample period for nontargets. I use two-sample t-tests on the equality of means between the sample of future targets and nontargets. The results are reported in columns (1)–(3) of Table 7. Consistent with the probit analysis, future targets have higher stock liquidity (lower *ILLIQUIDITY*), lower market valuation (higher *BM*), higher dividend payout ratio (higher *DIVIDENDS*), higher institutional ownership (higher *INST*), higher activist ownership (higher *INST-AHF*), and lower investment (lower *INVESTMENT*) than nontargets.

The univariate analysis also reveals that during the period that ends one year before the event, future targets perform better than nontargets in terms of both stock performance (higher *STOCK RETURN*) and operating performance (higher *ROA*). The average *ROA* ratio for future targets is 6.84%, whereas the average *ROA* ratio for nontargets is 4.18%, suggesting a meaningful difference in operating performance.

In addition to having higher dividend payout ratios, future targets are more likely to initiate dividend payments (higher *DIV. INITIATIONS*) and have higher repurchase ratios (higher *REPURCHASES*). For example, the probability that a nontarget firm initiates dividend payments in a given year is 1.36% for nontargets and 1.90% for future targets. Furthermore, future targets have lower leverage ratios (lower *LEVERAGE*): 17.54% for future targets versus 22.68% for nontargets. Finally, future targets have a higher *GINDEX*, suggesting a higher level of entrenchment (Gompers et al. 2003).

The above analysis compares cross-sectional differences in characteristics of future targets and those of nontargets. The analysis does not involve matching firms from two samples. I next compare average characteristics of future targets and nontargets for every year during the sample period. That is, I analyze how cross-sectional differences between targets and nontargets change over time. Results are reported in Figure 6.

I find that several differences in firm characteristics between future targets and nontargets are time persistent. Future targets have higher institutional ownership, higher activist ownership, lower leverage, and higher levels of share repurchases during most of the sample period. On the other side, some firm characteristics seem to matter during some years only. Future targets have higher returns on assets than nontargets during the pre-2000 period only. Similarly, future targets have higher stock liquidity during the pre-2010 period. Finally, the evidence indicates that when characteristics of future targets and nontargets are compared within each year, several differences in firm characteristics become insignificant (e.g., dividend initiations, investment, market cap).

To further sharpen the cross-sectional analysis, I compare future targets to matched firms. For each targeted firm, I identify a matching nontarget firm based on year, industry (three-digit SIC code), market cap, and book-to-market ratio. When market cap (book-to-market) is analyzed, market cap (book-to-market) is excluded from the matching criteria. The results are reported in columns (4)–(6) of Table 7. Consistent with the previous analysis, future targets are smaller than matched nontargets (lower *MV*), and they have higher stock liquidity (lower *ILLIQUIDITY*), lower market valuation (higher *BM*), lower leverage (lower *LEVERAGE*), and higher activist ownership (higher *INST-AHF*).

Interestingly, in contrast to the results of the previous analysis, the evidence here suggests that future targets invest *more* than matched nontargets. The average level of investment is 16.33% for future targets and 13.95% for nontargets, corresponding to a 17% difference in investments. This result is consistent with one of the major stated goals in the "business strategy" category. In such contests, dissidents often try to persuade a firm to adopt more conservative investment policies.

5.2. What Predicts Proxy Contests in Time Series?

In this section I analyze changes in firm characteristics of proxy contest targets during a period of years that

Table 7. Targets and Nontargets: Cross-Sectional Analysis

	Unpaired comparison			Paired comparison		
Variable	Targets, before (1)	Nontargets (2)	Diff (3)	Targets, before (4)	Nontargets, matched (5)	Diff (6)
BM	0.6917	0.5621	0.1296*** [4.71]	0.6904	0.6254	0.065** [2.23]
CASH	0.1860	0.1949	−0.0089 [−1.11]	0.1913	0.1772	0.0141 [1.59]
DIVIDENDS	0.2502	0.1970	0.0533*** [4.71]	0.2505	0.2707	−0.0202 [−1.43]
DIV. INITIATIONS	0.0190	0.0136	0.0054*** [2.96]	0.0174	0.0177	−0.0004 [−0.16]
GINDEX	8.891	8.610	0.281* [1.79]	8.975	8.850	0.125 [0.44]
ILLIQUIDITY	0.4581	0.6755	−0.2174*** [−7.17]	0.4660	0.5266	−0.0606** [−2.02]
INST	0.3964	0.2942	0.1021*** [9.07]	0.3969	0.4037	−0.0068 [−0.49]
INST-AHF	0.0383	0.0217	0.0166*** [10.54]	0.0373	0.0297	0.0076*** [3.09]
INVESTMENT	0.1589	0.1760	−0.0171* [−1.94]	0.1633	0.1395	0.0238*** [3.29]
LEVERAGE	0.1754	0.2268	−0.0514*** [−5.65]	0.1705	0.1972	−0.0266*** [−3.06]
MV	680	583	97 [1.29]	686	912	−226** [−2.54]
REPURCHASES	0.2520	0.2013	0.0507*** [2.95]	0.2595	0.2553	0.0043 [0.18]
ROA	0.0684	0.0418	0.0265*** [4.38]	0.0693	0.0621	0.0072 [1.24]
STOCK RETURN	0.0126	0.0051	0.0075*** [5.51]	0.0126	0.0108	0.0018 [1.44]

Notes. This table presents characteristics of proxy contest targets and nontargets. Each firm characteristic is first aggregated at the firm level by taking the average over a period of years that precede the event for targets and by taking the average over the sample period for nontargets. All variables are defined in Table 1. Column (1) reports cross-sectional averages for targets. Column (2) reports cross-sectional averages for nontargets. Column (3) reports differences between results for targets and nontargets and t-statistics of the differences. Columns (4)–(6) report paired comparison of targets and matching nontargets. For each targeted firm, we identify a match nontarget firm based on year, industry (three-digit SIC code), market cap, and book-to-market ratio. When market cap (book-to-market) is analyzed, market cap (book-to-market) is excluded from the matching criteria. Column (4) reports cross-sectional averages for targets with available matched nontargets. Column (5) reports cross-sectional averages for matched nontargets. Column (6) reports the average differences between targets and matched nontargets and t-statistics of the differences.

*, **, and *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

precede the event. To perform the analysis, I calculate average *within*-firm changes in characteristics of future targets before the event year. The results are reported in Table 8. Column (3) reports the average change in targets' characteristics between the period that precedes the pre-event year ("Before $(t-1)$") and the pre-event year $(t-1)$. Column (5) reports the average change in targets' characteristics between the period that precedes the pre-event year ("Before $(t-1)$") and the event year (t).

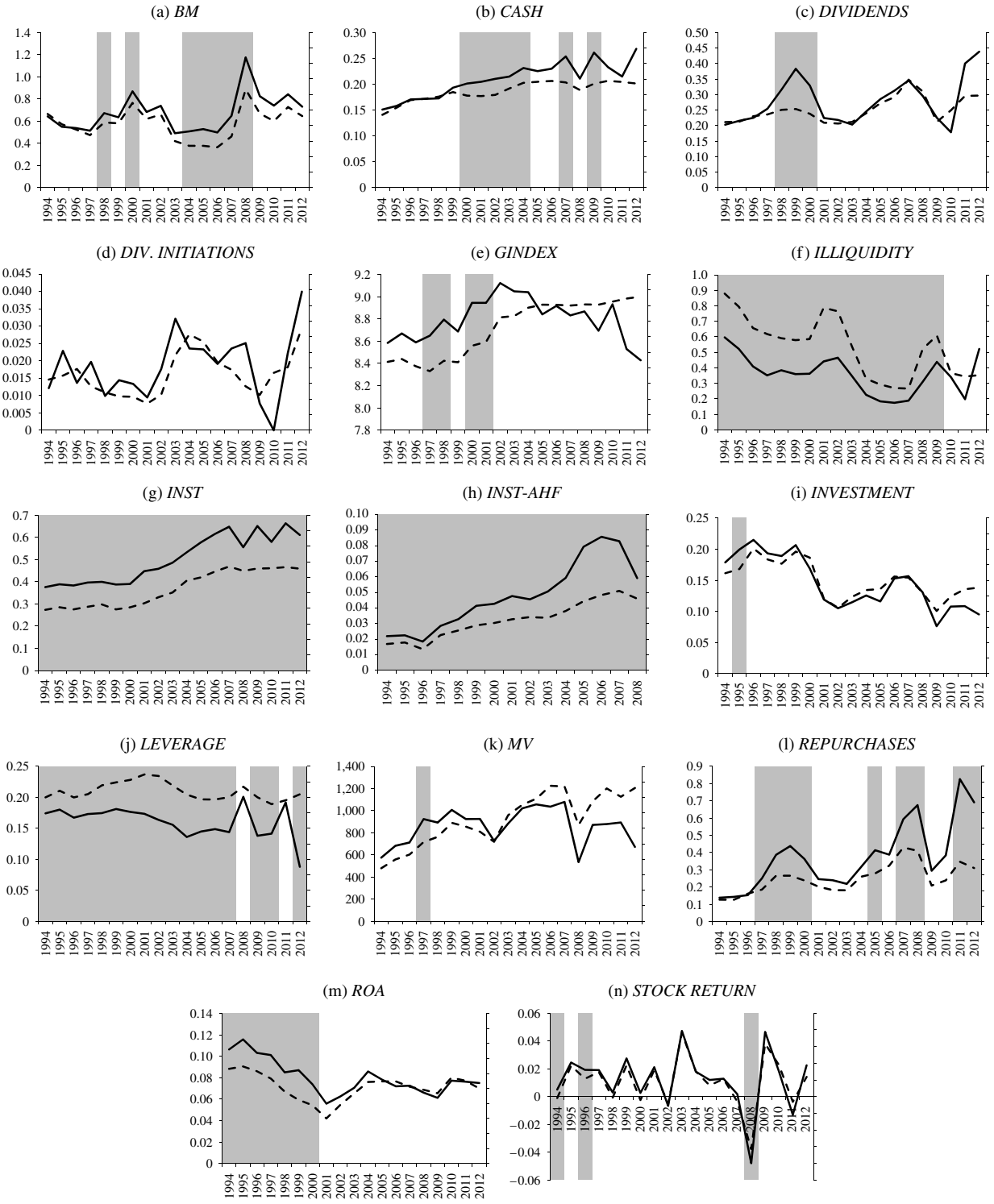
The evidence suggests that firms are targeted after a significant deterioration in all measures of performance. Stock returns, operating performance, and market valuation drop before firms are targeted. This is consistent with the results reported in §3.4: in 41% of proxy contests, dissidents indicate that the main goal of running such contests is reducing the general undervaluation of the target.

Increases in institutional ownership, as well as in activist hedge fund ownership, naturally precede proxy contest events. Thus, not only do targets have higher activist ownership when compared with nontargets in cross section but they also experience increases in activist ownership before the event starts. This result is consistent with higher stock liquidity predicting proxy contests.

I also find that targets experience increases in cash reserves during the proxy contest period. This is consistent with high cash reserves attracting activists' attention. Note that in about 13% of proxy contests, dissident sponsors indicate that they are seeking changes in capital structure, including decreasing cash reserves and increasing payouts to shareholders (see §3.4).

Some changes in corporate policies are consistent with the view that firms probably realize that the

Figure 6. Characteristics of Targets and Nontargets During Sample Period



Notes. Solid (dashed) lines plot characteristics of future targeted (nontargeted) firms during each fiscal year. Years in which the difference between the two groups was significant at the 10% level are shaded in gray. All firm characteristics are defined in Table 1.

likelihood of shareholder intervention increases: their firms exhibit poor stock and operating performance, high activist ownership, and high stock liquidity. These firms probably introduce changes in corporate policies that might reduce the likelihood of intervention. Consistent with this hypothesis, I find that future targets cut investments, increase payouts to shareholders, and increase the cost of intervention (higher *GINDEX*). Attempts to increase the cost of intervention are consistent with findings in Fos and Jiang (2016), who show

Table 8. Targets: Time-Series Analysis

Variable	Before $(t-1)$ (1)	$(t-1)$ (2)	Difference (3)	Event year, t (4)	Difference (5)
BM	0.7012	0.7899	0.0887*** [3.49]	0.8686	0.1674*** [6.18]
CASH	0.1904	0.2049	0.0145*** [2.97]	0.2000	0.0096** [2.51]
DIVIDENDS	0.2536	0.2918	0.0383* [1.83]	0.3319	0.0783*** [4.06]
DIV. INITIATIONS	0.0212	0.0198	−0.0013 [−0.21]	0.0355	0.0143** [2.38]
GINDEX	8.932	9.279	0.35*** [5.85]	9.248	0.32*** [6.09]
ILLIQUIDITY	0.4406	0.3721	−0.0686*** [−4.32]	0.4191	−0.0215 [−1.37]
INST	0.4159	0.4847	0.0688*** [8.29]	0.4715	0.0556*** [10.41]
INST-AHF	0.0390	0.0490	0.01*** [3.72]	0.0554	0.0165*** [6.66]
INVESTMENT	0.1752	0.1347	−0.0405*** [−5.51]	0.1112	−0.064*** [−9.92]
LEVERAGE	0.1752	0.1657	−0.0094* [−1.94]	0.1771	0.002 [0.21]
MV	652	745	93*** [2.95]	649	−3 [0.05]
REPURCHASES	0.2807	0.3600	0.0793* [1.82]	0.4666	0.1859*** [4.29]
ROA	0.0713	0.0735	0.0023 [0.51]	0.0566	−0.0147*** [−2.79]
STOCK RETURN	0.0095	0.0048	−0.0047** [−2.07]	−0.0054	−0.0149*** [−8.25]

Notes. This table presents characteristics of proxy contests targets before the event year. The sample period is 1994–2012. All variables are defined in Table 1. Column (1) reports the average characteristics of proxy contest targets during the period that ends two years before the event. Column (2) reports the average characteristics of proxy contest targets during the pre-event year. Column (3) reports the differences between results shown in columns (1) and (2) and t-statistics of the differences. Column (4) reports the average characteristics of proxy contest targets during the event year. Column (5) reports the average differences between results shown in columns (1) and (4) and t-statistics of the differences.

*, **, and *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

that incumbent chief executive officers increase their voting power in an attempt to maintain control.

6. What Do Firms Do When the Likelihood of Proxy Contest Increases?

What actions do firm managers take when the likelihood of proxy contests increases? A recent study by Fos and Tsoutsoura (2014) shows that proxy contests impose a significant adverse effect on the careers of incumbent directors. Following a proxy contest, directors experience a significant decline in the number of directorships not only in the targeted company but also in other nontargeted companies. Thus, it would be natural for incumbents to take actions that reduce the probability of a proxy contest. Indeed, the theoretical literature predicts that management can change corporate policies to reduce the probability of intervention (e.g., Grossman and Hart 1982, Fos and Kahn 2015).

To investigate the possibility that corporate policies change when the likelihood of a proxy contest increases, I estimate a specification in which corporate policies are regressed on the likelihood of a proxy contest:

$$y_{it} = \gamma_1 \widehat{PC}^{*}_{it} + \eta_t + \eta_i + u_{it}, \quad (2)$$

where y_{it} is a corporate policy of interest, η_t are time fixed effects, η_i are firm fixed effects, and $\widehat{PC}^{*}_{it}$ is the estimate of the likelihood of a proxy contest from Table 6. Because regressions include firm fixed effects, the estimates are based on within-firm variations in the likelihood of a proxy contest and within-firm variations in corporate policies. When a corporate policy is analyzed, it is excluded from the probit regression and therefore does not enter $\widehat{PC}^{*}_{it}$. Table 9 reports estimates of Equation (2), using which I analyze the effect of the likelihood of a proxy contest on capital structure (leverage and cash reserves), investments, and payouts (dividends and share repurchases).

Table 9 shows that the likelihood of a proxy contest is significantly correlated with changes in major cor-

Table 9. The Likelihood of a Proxy Contest and Corporate Policies

Dependent variable:	*LEVERAGE* (1)	*CASH* (2)	*INVESTMENT* (3)	*DIVIDENDS* (4)	*REPURCHASES* (5)
			Panel A: Full sample		
$\widehat{PC}^*$	0.0308***	−0.0273***	−0.1279***	0.0949***	0.0199**
	[0.0041]	[0.0036]	[0.0046]	[0.0138]	[0.0080]
Observations	55,211	55,215	55,799	55,195	55,270
R^2 (%)	2.90	1.30	8.50	2.30	2.90
			Panel B: Nontargets		
$\widehat{PC}^*$	0.0298***	−0.0268***	−0.1256***	0.0942***	0.0225***
	[0.0042]	[0.0038]	[0.0048]	[0.0139]	[0.0082]
Observations	51,209	51,213	51,766	51,192	51,266
R^2 (%)	3.00	1.20	8.30	2.30	3.00
Year FE	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes

Notes. This table studies the relation between the likelihood of a proxy contest and corporate policies. The table reports estimates of γ_1 from the following regression: $y_{it} = \gamma_1 \widehat{PC}^*_{it} + \eta_t + \eta_i + u_{it}$, where y_{it} is a corporate policy of interest, η_t are time fixed effects, η_i are firm fixed effects, and $\widehat{PC}^*_{it}$ is the estimate of the likelihood of a proxy contest from Table 6. When a corporate policy is analyzed, it is excluded from the probit regression and therefore does not enter $\widehat{PC}^*_{it}$. These regressions cover all Compustat firm-year observations from 1994 through 2012. All variables are defined in Table 1. Panel A reports the results for the full sample. Panel B reports the results for nontargets. In each column, I report estimated coefficients and heteroscedasticity robust standard errors clustered by firm. FE, fixed effects.

*, **, and *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

porate policies. The coefficient of $\widehat{PC}^*_{it}$ suggests that when the likelihood of a proxy contest increases, firms increase leverage and decrease cash reserves. As far as the investment policy is concerned, companies invest less when the likelihood of a proxy contest increases. Finally, the likelihood of a proxy contest is positively and significantly correlated with payouts. Companies increase dividends and share repurchases when the likelihood of a proxy contest increases. Overall, the evidence indicates that, following an increase in the likelihood of proxy contests, potential targets are more likely to change corporate policies in the direction that is favored by dissident shareholders.[13]

Overall, the evidence indicates that there is a significant correlation between the likelihood of a proxy contest and corporate policies.[14] This result is consistent with the proxy contest mechanism having strong disciplinary effects. Specifically, the threat of a proxy contest (as measured by the probability of a proxy contest) may affect major corporate policies, including capital structure, investments, and payouts. Overall, the evidence is consistent with the proposition that the disciplinary effects alleviate the agency problem between managers and outside shareholders. The evidence also implies that an assessment of a corporate governance mechanism cannot be based on materialized events only. Instead, the analysis should start from studying the disciplinary effects.

7. Conclusion

This paper studies all proxy contests from 1994 through 2012. I describe time-series distribution of proxy contests and document key characteristics of proxy contest targets. Moreover, I show the effects of proxy contests on shareholder wealth and study how these effects depend of types of dissident shareholders and their stated goals. Finally, I study which firm characteristics predict proxy contests, both in cross section and in time series.

The main contribution of this paper is to the corporate governance literature. The paper shows that there was a significant shift in hostile corporate governance: proxy contests have become substitutes for hostile takeovers. Importantly, the proxy contest mechanism is effective in creating value for shareholders of targeted firms. The paper also shows that firms are changing corporate policies when the likelihood of a proxy contest increases. This result is consistent with the proxy contest mechanism having strong disciplinary effects. Future research could provide a causal interpretation to this result.

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Endnotes

[1] In an attempt to facilitate corporate governance, on July 21, 2010, the SEC received authorization from the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203) to adopt proxy access rules and adopted significant proxy access reform on August 25, 2010. This reform addresses concerns about the effectiveness of the proxy contest mechanism by facilitating the process of nominating directors by large long-term shareholders (Rule 14a-11). The reform would reduce these cost barriers by allowing shareholder nominations to be included in the corporate proxy materials. On September 29, 2010, the U.S. Chamber of Commerce and Business Roundtable jointly filed a petition with the United States Court of Appeals for the District of Columbia Circuit alleging that the reform violated several federal statutes. On October 4, 2010, pending a judicial decision, the SEC agreed to stay implementation of the reform. On July 22, 2011, calling the rule arbitrary and capricious, the appeals court voted to vacate Rule 14a-11, a ruling that the SEC decided not to appeal. See Becker et al. (2010) and Cohn et al. (2014) for further details.

[2] An exception is Norli et al. (2015), who study shareholder proposals and proxy contests during the 1994–2007 period. Their sample includes 331 proxy contests, a subsample of 1,061 proxy contests I analyze.

[3] Alexander et al. (2010) and Fos and Tsoutsoura (2014) use a similar approach to identify proxy contests.

[4] A total of 1,061 unique proxy contests correspond to 873 firms, suggesting that about 20% of firms are targeted more than once.

[5] The increase in the frequency of proxy contests between 2005 and 2008 is consistent with procyclical shareholder activism. On the theoretical side, Burkart and Dasgupta (2014) develop a model in which shareholder activism is procyclical. On the empirical side, similar time-series properties are observed for hedge fund activism campaigns (see Brav et al. 2008).

[6] Rule 14a-8 of the Securities Exchange Act of 1934 gives a shareholder who meets certain threshold requirements the right to require management to include his proposal in management's proxy materials. Rule 14a-8 is commonly referred to as the "shareholder proposal rule." It states that to be eligible to submit a proposal, a shareholder either must have continuously held at least $2,000 in market value or 1% of a company's securities for at least one year or be a registered holder. Management, however, may exclude an eligible proposal from proxy materials if the proposal relates to an election to membership on the company's board of directors or the proposal directly conflicts with one of the company's own proposals.

[7] http://www.sec.gov/Archives/edgar/data/105418/000089882299-000662.txt.

[8] http://www.sec.gov/Archives/edgar/data/353020/000090951897-000368.txt.

[9] In the first proposal, the board wanted to amend the company's certificate of incorporation to (a) prohibit stockholder action by written consent and (b) preclude the ability of stockholders to call a special meeting. In the second proposal, the board wanted to amend the company's certificate of incorporation to allow for the issuance of one or more series of preferred stock, the rights, preferences, and privileges of which would be designated by the board of directors.

[10] The proxy contest sponsored by Elliott Associates against Metromedia International Group is an example of a proxy contest sponsored by an activist hedge fund: http://www.sec.gov/Archives/edgar/data/39547/000095011701501157/a31302.txt. The proxy contest sponsored by Pfizer against Warner Lambert is an example of a proxy contest sponsored by a corporation: http://www.sec.gov/Archives/edgar/data/78003/0000950123-99-010992.txt. The proxy contest sponsored by SEIU Pension Funds against Columbia HCA Healthcare is an example of a proxy contest sponsored by a pension fund: http://www.sec.gov/Archives/edgar/data/860730/0001037673-98-000003.txt. The proxy contest sponsored by Allen E. Bender against TVI Corporation is an example of a proxy contest sponsored by an insider: http://www.sec.gov/Archives/edgar/data/352079/000113379608000187/tv80473.htm. The proxy contest sponsored by the Committee to Revitalize Endocare against Endocare is an example of a proxy contest sponsored by a group of shareholders.

[11] http://www.sec.gov/Archives/edgar/data/353020/000090951897-000368.txt.

[12] Collin-Dufresne and Fos (2015) use data on trading strategies of activist investors and show that activists are more likely to purchase shares when stock liquidity is high.

[13] This evidence fits well with other findings in the existing literature. For example, positive effects of stronger shareholder control on leverage are documented in studies of the implications of the second-generation antitakeover legislation (Garvey and Hanka 1999). Similarly, it has been shown that leverage increases in the aftermath of entrenchment-reducing shocks to managerial security (Berger et al. 1997, Safieddine and Titman 1999). Changes in investment policy are consistent with evidence reported by Safieddine and Titman (1999) and Garvey and Hanka (1999), who document that when targets increase their leverage ratios to prevent a control challenge, they also reduce capital expenditures. Finally, previous studies document the positive relationship between the strength of corporate governance and dividend payouts (La Porta et al. 2000). The positive disciplinary effect of proxy contests on payouts is also consistent with the results of a survey conducted by Allen and Michaely (2003), suggesting that management can commit to paying out cash because of the constant threat of disciplinary action.

[14] The analysis does not, however, imply a causal relation. To do so, one needs a source of exogenous variation in the likelihood of a proxy contest. Unfortunately, finding an instrument for proxy contests at the firm level is hard, if not impossible. For example, Collin-Dufresne and Fos (2014) show that under certain conditions, the market cannot figure out whether an improvement in firm value after an activism event is due to the causal impact of the activist on a firm's value or due purely to the timing of the activist campaign.

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