Corporate Voting

Shareholder voting in the Internet age

Coho Energy, 1999

- Company files for bankruptcy, cancels annual meeting
- Angry shareholders on Yahoo! message board:

1. David Marx, real estate appraiser, aka “Stockmeister7”:

   “I would vote for a new CEO and I have 125,000 shares toward that end. Who else would support this. Please post your vote and the number of shares you have to vote for a replacement.”

2. J.D. Davis, header of truck driver’s union controlling 742,000 shares:

   “Stockmeister you have our total support and proxie. Let’s get together on this and oust the guy. It’s time he got a job driving a forklift.”

- 13,000,000 shares, or 52% outstanding, are pledged to Stockmeister7. Judge names him head of the shareholders committee in Chapter 11.

Is anything wrong with this?

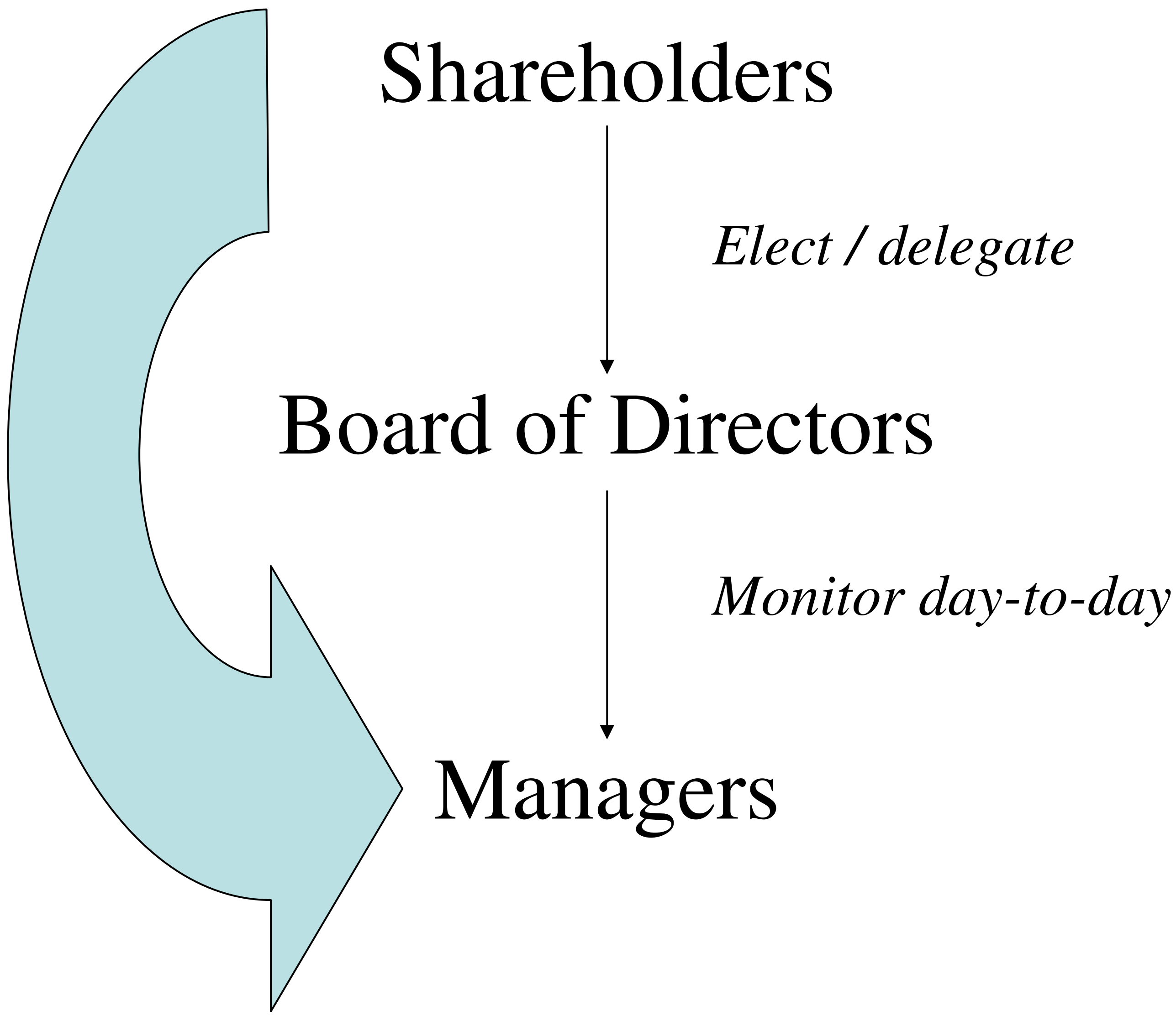
- Violates anti-fraud proxy disclosure rules

- Solicits votes for an election that will never be held
  - CEO is not elected by shareholders
  - No elections are held by companies in Chapter 11

What’s interesting about this

- Internet dramatically reduces time and cost required for shareholder communication

- Seems to resolve “collective action problems” that are the rationale for limited shareholder participation in governance


Shareholders
Elect / delegate
Board of Directors
Monitor day-to-day
Managers

Shareholder voting is changing

THE WALL STREET JOURNAL.

BUSINESS | Updated June 8, 2012, 6:49 p.m. ET

Chesapeake Directors Rejected by Shareholders

By RUSSELL GOLD And DANIEL GILBERT

Chesapeake plans to sell assets in three transactions totaling more than $4 billion in cash, as the natural-gas company struggles against mounting debt. Daniel Gilbert reports on Markets Hub. Photo: Bloomberg.

OKLAHOMA CITY—Chesapeake Energy Corp. shareholders rebuked the company's management at the annual meeting here Friday, overwhelmingly voting against the two directors standing for re-election.

V. Burns Hargis, president of Oklahoma State University, and Richard Davidson, former chief executive of Union Pacific Corp. received only 26% and 27%, respectively, of votes cast. Both tendered their resignations, the company said, under a new measure that requires directors who don't receive a majority of votes to offer to resign. Chesapeake said its board would "review the resignations in due course."

The two men received the lowest support of any S&P 500 company director in the past five years, according to Institutional Shareholder Services.

- More direct involvement in governance
  - Say-on-pay
  - Majority board elections
  - [Proxy access]
- Regulatory reform to improve transparency
  - End of “broker voting” in 2010 (c. 15% cushion)
  - Publicity of mutual fund votes
- Aggressive tactics by active investors
  - “Empty voting”
  - “Loan to own”

Why should we care?

1. <u>The good reasons:</u>

(a) Surprisingly large effects on value of equity and debt

(b) Effective communication channel with management

2. <u>The troubling reasons:</u>

Weaknesses of technology and regulation create opportunities for vulture investors to destabilize companies

Voting
and the value of the firm

THE WALL STREET JOURNAL.
WSJ.com

BUSINESS Updated April 17, 2012, 9:57 p.m. ET

Citigroup Investors Reject Pay Plan

By SUZANNE KAPNER, JOANN S. LUBLIN and ROBIN SIDEL

Shareholders of Citigroup Inc. on Tuesday handed the bank a scathing rebuke, rejecting a board-approved compensation package for its senior executives that boosted Chief Executive Vikram Pandit's 2011 pay to $14.9 million from $1 a year earlier.

The shareholder vote, mandated by the Dodd-Frank financial overhaul law, is nonbinding and won't require Mr. Pandit or Citigroup's other executives to give back pay they have already received. But it is a rare setback for a large corporation and could force Citigroup to rethink aspects of its executive-pay practices. Corporate governance advisers had criticized Citigroup's plan because it failed to closely link pay to performance.

Bloomberg News

Citigroup shareholders rejected a board-approved compensation package for CEO Vikram Pandit.

The result "is a serious matter," Citigroup Chairman Richard Parsons said at the end of the company's annual meeting in Dallas, where the shareholder vote occurred. The directors will consult with shareholder groups to determine their concerns, he said. Shareholders also approved the appointment of Michael O'Neill as chairman, replacing Mr. Parsons, who is stepping down.

Citigroup is the first major bank and the biggest company by market value to have suffered a no vote on executive compensation.

The setback followed negative recommendations by two proxy-voting firms widely followed by institutional investors, and could foreshadow increasing shareholder activism. The California Public Employees' Retirement System, a major shareholder, voted against Citigroup's executive-pay practices because "the bank has not anchored rewards to performance," spokesman Brad Pacheco said.

The reversal comes a month after the Federal Reserve delivered Citigroup a blow by turning down its request for a share buyback or dividend following "stress tests" by the Fed to see how the bank would fare in a severe financial downturn. It follows years of poor stock-market performance at Citigroup, whose shares have lost 93% of their value since 2006, thanks in part to billions of shares issued to repay a 2008-2009 government bailout.

Stock +3.2%

= $3 billion gain in market cap

Pandit's 2011 pay:

- $1.6 mm salary
- $5.3 mm bonus
- $7.8 mm options
- "retention award"

Shareholder resolutions

John J. Gilbert Is Dead at 88; Gadfly at Corporate Meetings

By DOUGLAS MARTIN

John J. Gilbert, one of the earliest and most persistent gadflies to speak out at annual meetings on behalf of small shareholders — dramatizing his demands with such attention-getting props as a red clown's nose — died on Monday at his daughter's home in Denver. He was 88.

Margot Gilbert Frank, his daughter, said he became ill last September while attending a reception to honor his establishment of a chair in accounting at the University of Denver. He never returned to his home in Manhattan.

Mr. Gilbert and his older brother, Lewis, each attended more than 80 annual meetings a year to press what they called corporate democracy. By persistently questioning chief executives — not a few of whom considered it badgering — they succeeded in prodding more companies to hold annual meetings in accessible locations, to issue post-meeting reports, to limit stock options for executives and to require the independent auditors of companies to attend meetings.

Some companies were persuaded to adopt one of the Gilberts' pet ideas, cumulative voting for directors, which improves the chance of minority shareholders to name board representatives. Under this method, shareholders are permitted to cast all their votes for one candidate.

As a result of cumulative voting, "we can get honest directors on the board," Mr. Gilbert argued. "We want to keep these companies honest."

Mr. Gilbert brought more flair to the campaign than his more cerebral brother. At a PepsiCo meeting, he donned his clown nose and asked why none of the directors were wearing PepsiCo ties.

After being kicked out of a Chock Full o' Nuts meeting, he returned the next year with two pairs of boxing gloves hanging from his neck.

The result approached outright theatricality in settings where a few shareholders had formerly gathered in small numbers to quickly and quietly pass the management agenda. Wilma Porter Soss, who once dressed as a cleaning woman to protest the quiz show scandals at CBS, and Evelyn Y. Davis, who waved an American flag at a General Motors meeting, were others who brought showmanship to the fight for shareholder rights. Sometimes, all appeared at the same meeting.

But the Gilberts were leaders. In 1983, they proposed 198, or 20 percent, of the 972 resolutions proposed at annual meetings, according to the American Society of Corporate Secretaries. The next closest, with 100, was Andrew W. Duncan, a champion of conservative causes.

John Jacob Gilbert was born in Manhattan on May 8, 1914. His father had owned part of a paper mill, but sold it and lived from investments.

"I was born with a silver spoon and polished it," Mr. Gilbert said. He attended private schools and graduated from Patrick Business School, since closed, in Manhattan.

He and his brother started attending annual meetings in the 1930's, at first just to watch over their investments. But Mrs. Frank — who along with three grandchildren and four great-grandchildren survives Mr. Gilbert — said they were "appalled" at what they saw.

"It was like going to a private club," she said. "It was the good old boys."

So they amassed relatively small blocks of stock in 1,500 companies, initially as an investment. Because of this, their early complaints often concerned companies that paid no dividends, but greatly increased executives' compensation.

Mr. Gilbert considered his 1946 stand against the insurance company Transamerica a defining moment

The New York Times

John J. Gilbert, 1972

for outside shareholders. He proposed moving its annual meeting from Delaware, the state of incorporation, to California, where operations were. He further proposed that shareholders approve management's choice of auditors, and that those who could not attend be provided minutes.

A result was that the Securities and Exchange Commission began to require that relevant shareholder resolutions be included in proxy statements. Mr. Gilbert called this ruling "the Magna Carta" for small shareholders. Not only did this propel his push for shareholders' economic rights, but such diverse shareholders as unions and churches started using proposals in proxies to advocate social and political causes.

For 40 years, ending in 1979, the Gilberts published an annual compendium of activities at corporate meetings. They, of course, were often at the center of the action.

At a Macy's annual meeting in 1963, for instance, John Gilbert railed against "management stooges."

Jack I. Strauss, the company's chairman, replied, "Mr. Gilbert, we love you."

Any shareholder may propose a ballot question, subject to modest eligibility restrictions (must own $2,000 for 1 year)

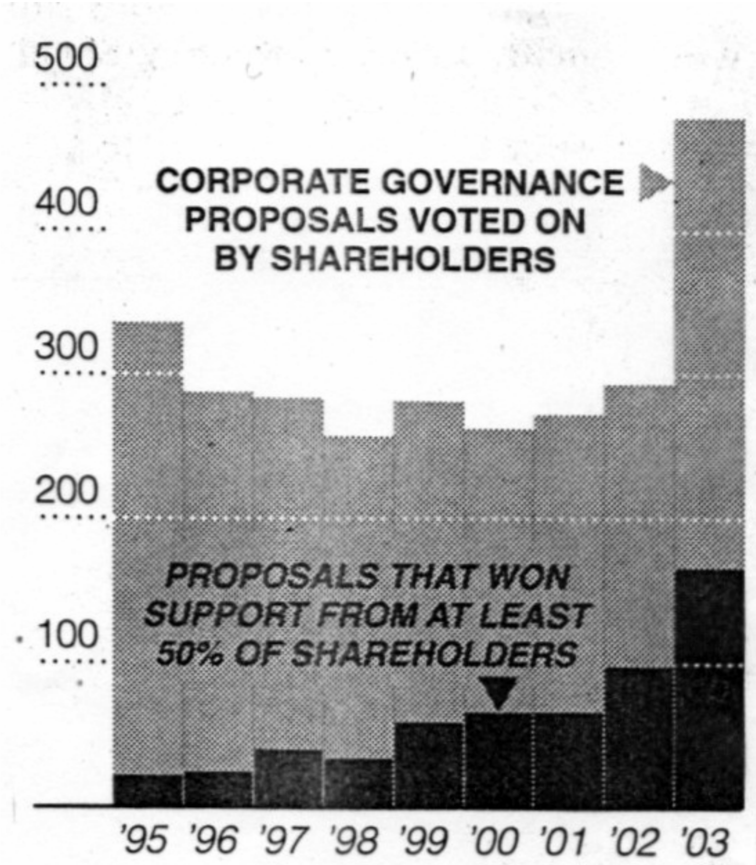
Must be advisory and non-binding

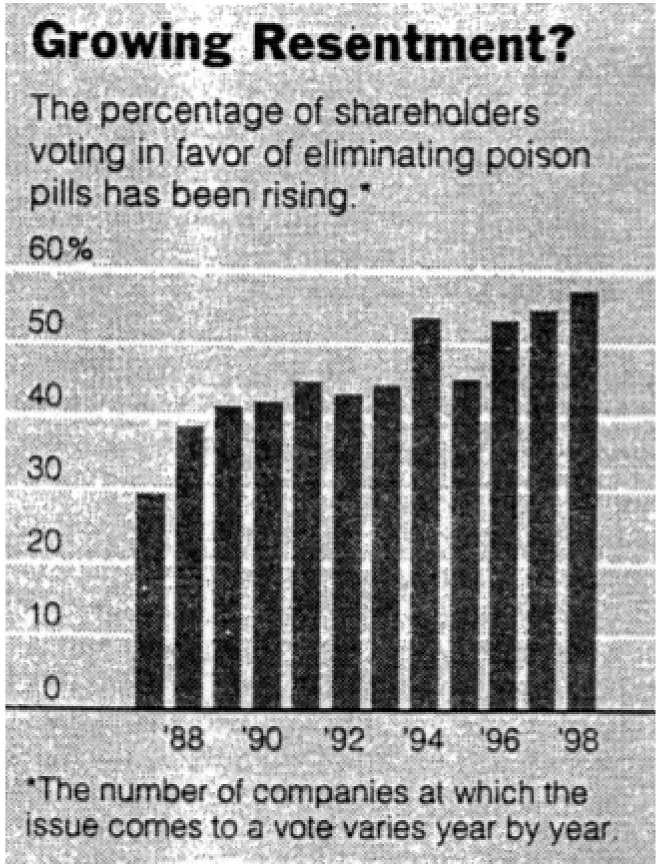
Subject matter limitations:

- Not about "ordinary business"
- Not targeted at general social issues

May submit it again the following year if it receives at least modest support from other voters

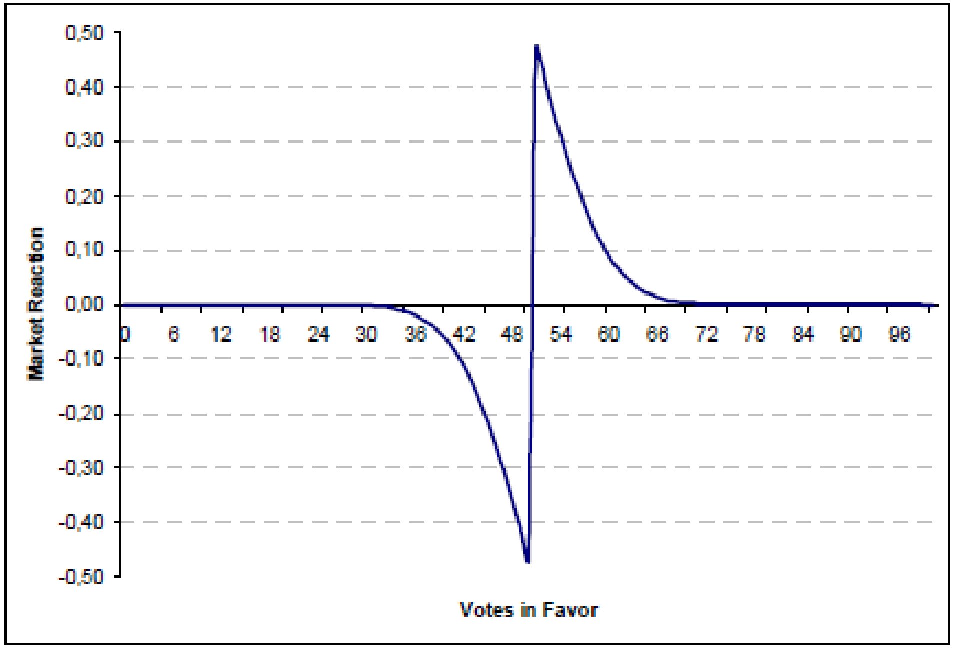
Governance proposals





Shareholder value impact when a takeover defense proposal passes

• All votes	0.01%
• 60% or less	0.21%
• 55% or less	0.94%
• 52% or less	1.62%
• 51% or less	2.21%



Most vote outcomes are easy to forecast; close votes implicitly show the value of governance changes

Source: Cunat, Gine & Guadalupe (2011)

These results are *surprising*

- Large magnitude
- The proposals are non-binding
- Management can greatly influence the outcome
- Management can “surrender” and avoid the value loss

What are voting rights worth?

- Research into stock lending suggests value is low
- In nearly all elections, value of a marginal vote is meaningless
- But sometimes it matters a lot

What are voting rights worth?

- Zingales' (1994) study of dual-class shares on the Milan stock exchange:

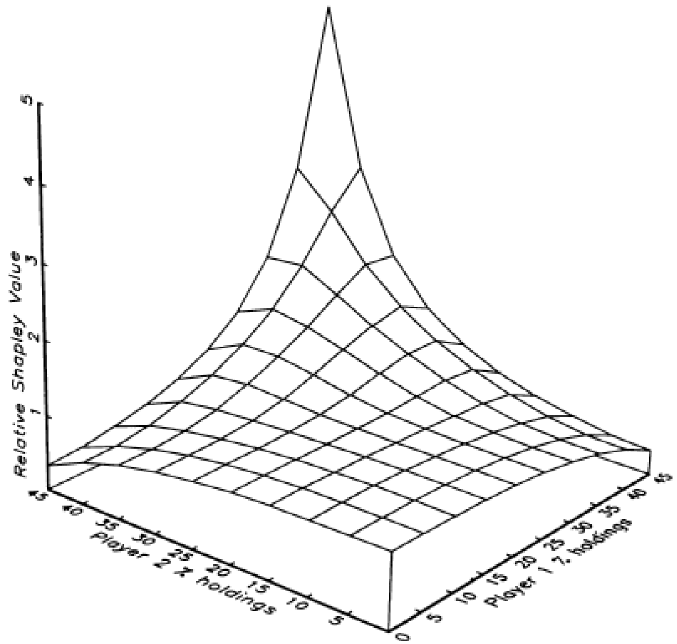


Figure 1
Relative Shapley value of small shareholders in the presence of two large shareholders
The relative Shapley value is the Shapley value of the block of shares held by small shareholders divided by the total size of their block (RSV). In the figure I represent this value for a game with only two large shareholders.

Source: Zingales (1994)

U.S. example: Resorts International

- Controlling shareholder dies unexpectedly without an heir

Source: Zingales (1994)

U.S. example: Viacom

Learning Redstone's A's and B's

Is a voting share in **Viacom** more valuable than its more-ubiquitous nonvoting sibling?

At least some investors appear to think so.

The usually nonexistent spread between Viacom's A class voting shares and B class nonvoting shares has widened to roughly 10% since mid-October, when news broke of financial pressures on Viacom's controlling shareholder Sumner Redstone. Monday, for example, Viacom A was trading at $15.89 and B was at $14.30.

Viacom Chairman Sumner Redstone

It may be that the spread is caused by funds selling the more plentiful B shares rather than the tightly held A's. But it may also be a bet by some traders that in any sale of Viacom, the company's A class shares—81.6% of which are owned by Mr. Redstone—will benefit more than the B's. He only owns 3% of the B's.

It is a somewhat risky bet. Mr. Redstone has repeatedly vowed that he wouldn't sell Viacom. Indeed his family holding company, National Amusements, has other assets it could sell to reduce its $1.6 billion debt, which faces a looming deadline for renegotiation, including a controlling stake in **CBS** and a closely held theater chain. On Friday he sold his control of videogame company Midway Games.

Still, Mr. Redstone's stake in Viacom is probably the most attractive asset in his portfolio given Viacom's ownership of MTV, Nickelodeon and Comedy Central. Mr. Redstone might find it harder to lure a buyer for CBS, whose broadcast-television and radio businesses are more exposed to the advertising slump.

In addition, a buyer theoretically could get control of Viacom by just buying Mr. Redstone's voting stake. As his Viacom A shares have a market value of about $750 million, compared with Viacom's total market capitalization of about $9 billion, buying his A's only would be far easier to finance.

Such a deal would pose serious obstacles for most potential buyers. It would attract massive litigation from outraged nonvoting shareholders—assuming it was struck at a premium price. And to comply with their fiduciary obligations to those investors, Viacom's independent directors probably would oppose the deal.

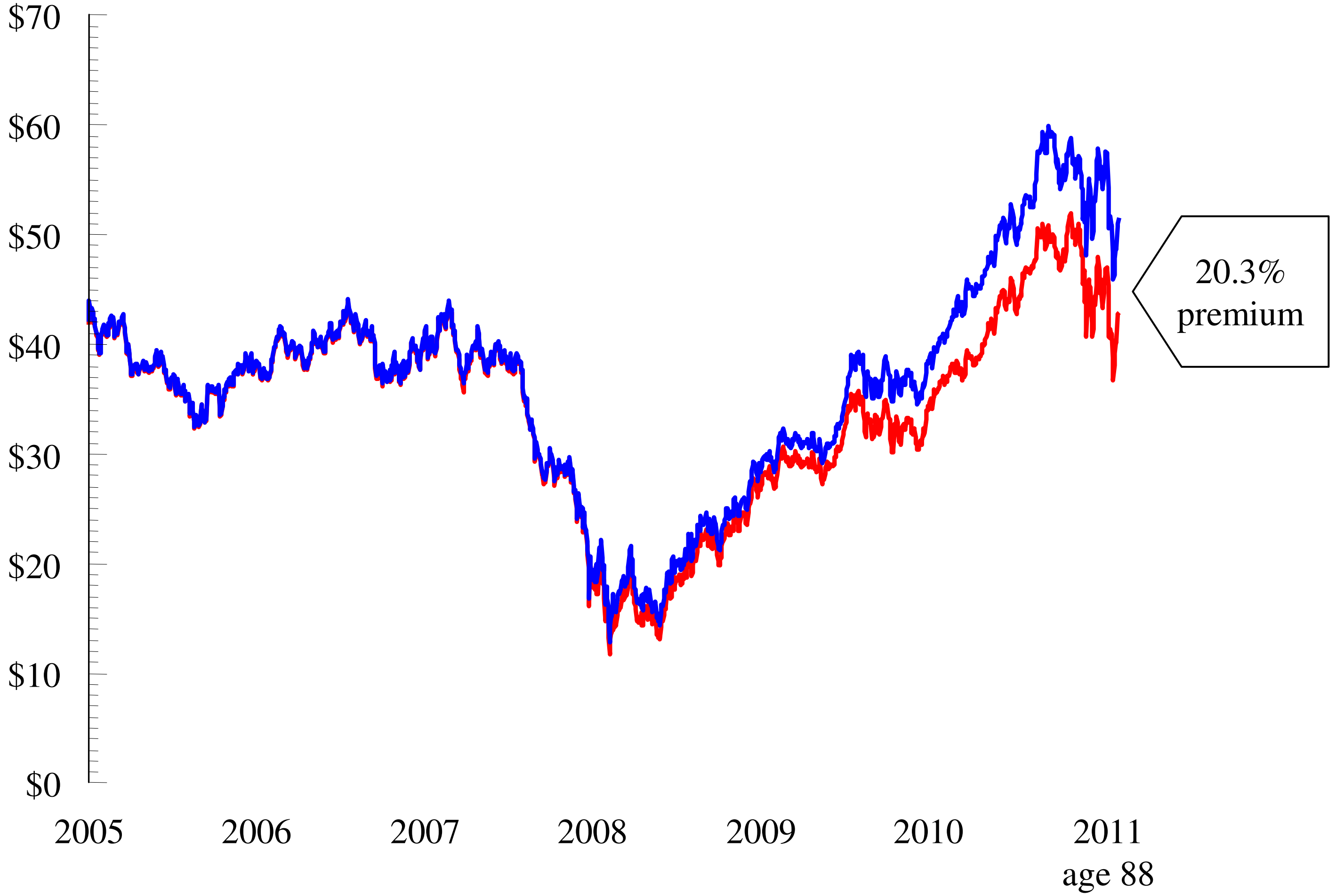
Delaware corporate law allows a buyer to circumvent the need for board approval by acquiring more than 85% of voting stock in a transaction. Someone could tender for all the A shares, or buy 5% in the market and then negotiate a private deal with Mr. Redstone to reach the 85% threshold.

Even then, the board could have the last laugh, by introducing a poison pill to cut off the buyer at the knees. That would imply outright war between Mr. Redstone and other directors, with an outcome nobody can predict.

But with Mr Redstone under serious pressure, and in a bear market as brutal as this, anything is possible.

—Martin Peers

U.S. example: Viacom



What are voting rights worth? A contingent claims approach

- By put-call parity,

  Stock = + call option

  – put option

  + bond

- Compare the value of this synthetic share of stock with the market price of an actual share

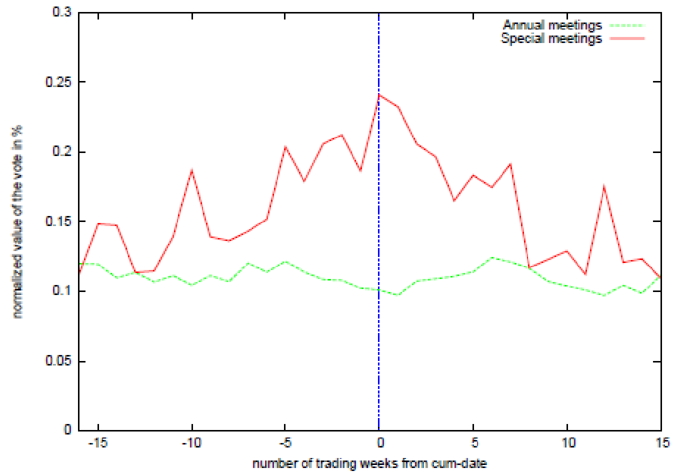
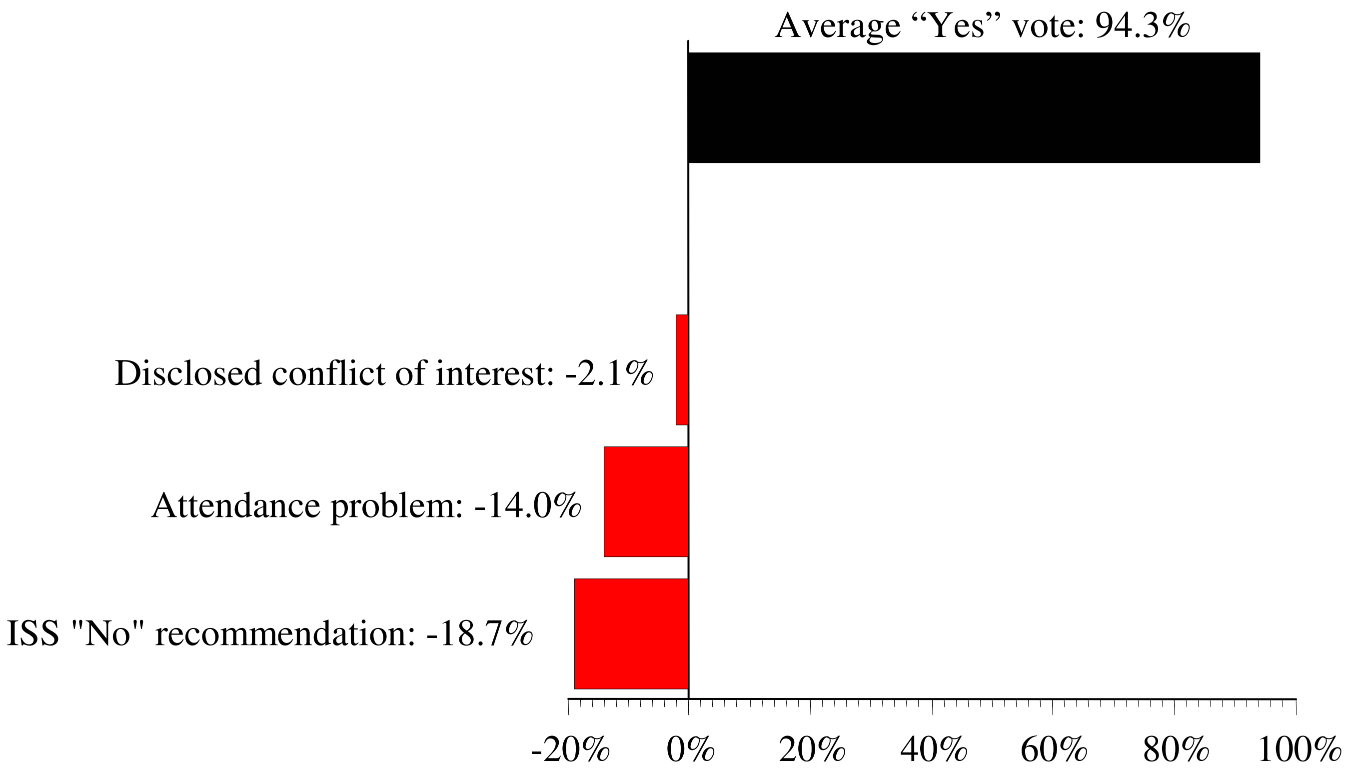


Figure 2. Value of the Vote around Voting Events: This figure characterizes the time series variation of the normalized market value of the vote around annual and special meetings during the time period 1998 through 2007. The value of the vote is calculated as the difference between the price of the stock and the price of the synthetic stock normalized by the price of the stock. The synthetic stock is constructed as $\hat{S}(T) = C - EEP_{call} - P + EEP_{put} + PV(X) + PV(div)$, where C is the price of the call option with strike X and T days to maturity, P is the price of the put option with strike X and T days to maturity, $PV(X)$ is the present value of investing in a bond with face value X, $PV(div)$ is the present value of the dividend stream prior to option expiration, EEP_{call} is the early exercise premium of the call option, and EEP_{put} is the early exercise premium of the put option. The early exercise premiums for the call and put options are calculated using the Binomial option pricing model with 1000 steps. The figure plots the average value of the vote for 16 trading weeks prior to the cum-date and 16 trading weeks after the cum-date for special meetings and annual meetings.

Source: Kalay, Karakas & Pant (2011)

Voting
as a channel of communication

Director elections in the U.S.



Source: Cai, Garner and Walkling (2009)

Real effects

- *Director resignations:* no clear pattern

- *CEO dismissals:* One standard deviation drop in voting for outside directors increases CEO turnover by 121%

- *CEO compensation:* 1% reduction in votes for a comp. committee member reduces CEO pay by $143,000 in the next year.

Example: Bank of America in 2009

Tommy R. Franks	92%	Resigned
Thomas J. May	92%	
John T. Collins	92%	Resigned
William Barnet, III	92%	Resigned
Walter E. Massey	92%	Resigned
Charles K. Gifford	91%	
Patricia E. Mitchell	87%	Resigned
Gary L. Countryman	86%	Resigned
Charles O. Rossotti	85%	
Joseph W. Prueher	85%	Resigned
Virgis W. Colbert	85%	
Thomas M. Ryan	83%	Resigned
Frank P. Bramble, Sr.	77%	
Robert L. Tillman	75%	Resigned
Monica C. Lozano	74%	
Jackie M. Ward	71%	Resigned
Kenneth D. Lewis (Chairman & CEO)	**66%**	Resigned
O. Temple Sloan, Jr..(Lead Director)	62%	Resigned

Example: News Corp. in 2011

Murdoch Sons Drew Opposition in Votes

BY RUSSELL ADAMS

The re-elections of Rupert Murdoch's sons, James and Lachlan, to the board of News Corp. drew heavy opposition at the company's annual meeting last Friday, with about one-third of voting shares that were cast going against the pair, according to a securities filing on Monday.

James Murdoch, News Corp.'s deputy chief operating officer, received 433 million votes in favor of his re-election as a director but about 232 million, or 34%, of the votes were cast against him. About 224 million votes, or about 33% of the total, were cast against the re-election of his brother Lachlan, according to the filing. Roughly 91.8 million votes, or about 13% of those cast, went against Rupert Murdoch, the company's chairman and chief executive.

News Corp. owns The Wall Street Journal.

The Murdoch family and Saudi investor Prince Alwaleed bin Talal together control nearly half of the voting shares of News Corp. The prince expressed support for Rupert and James Murdoch as recently as July.

Excluding their stakes, the vote against James Murdoch represented about 75% of the votes cast. On the same basis, the votes against Rupert and Lachlan Murdoch represented about 30% and 72%, respectively, of the votes cast.

A News Corp. spokesman declined to comment on the tallies.

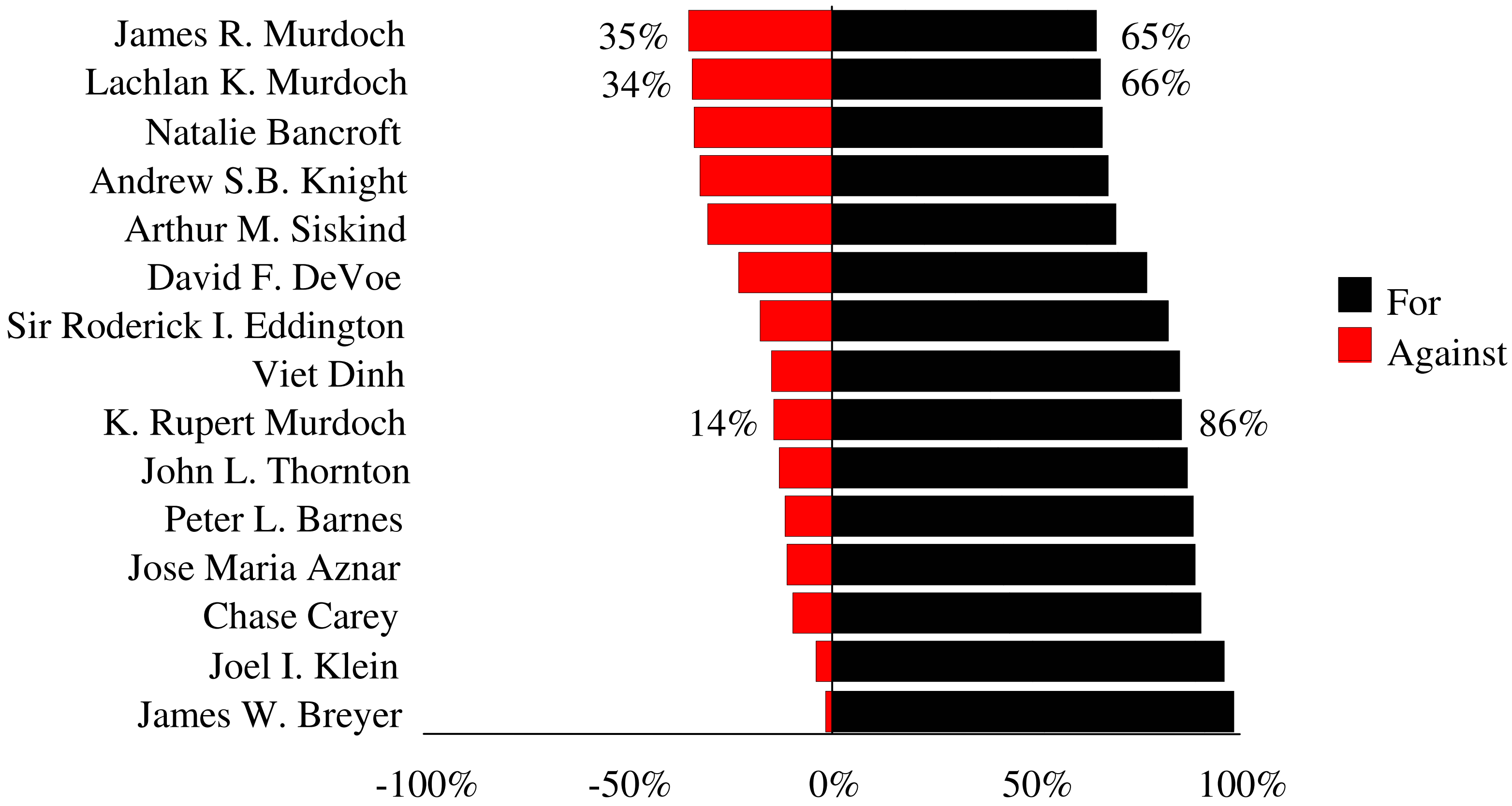
James Murdoch has come under fire in recent months for his role in News Corp.'s response to allegations that journalists at the company's now-defunct News of the World newspaper in Britain intercepted voice messages in pursuit of scoops.

The scandal, which resulted in more than a dozen arrests and multiple criminal investigations, also elicited calls for an overhaul of the News Corp. board, which some shareholders say lacks the independence to provide proper oversight.

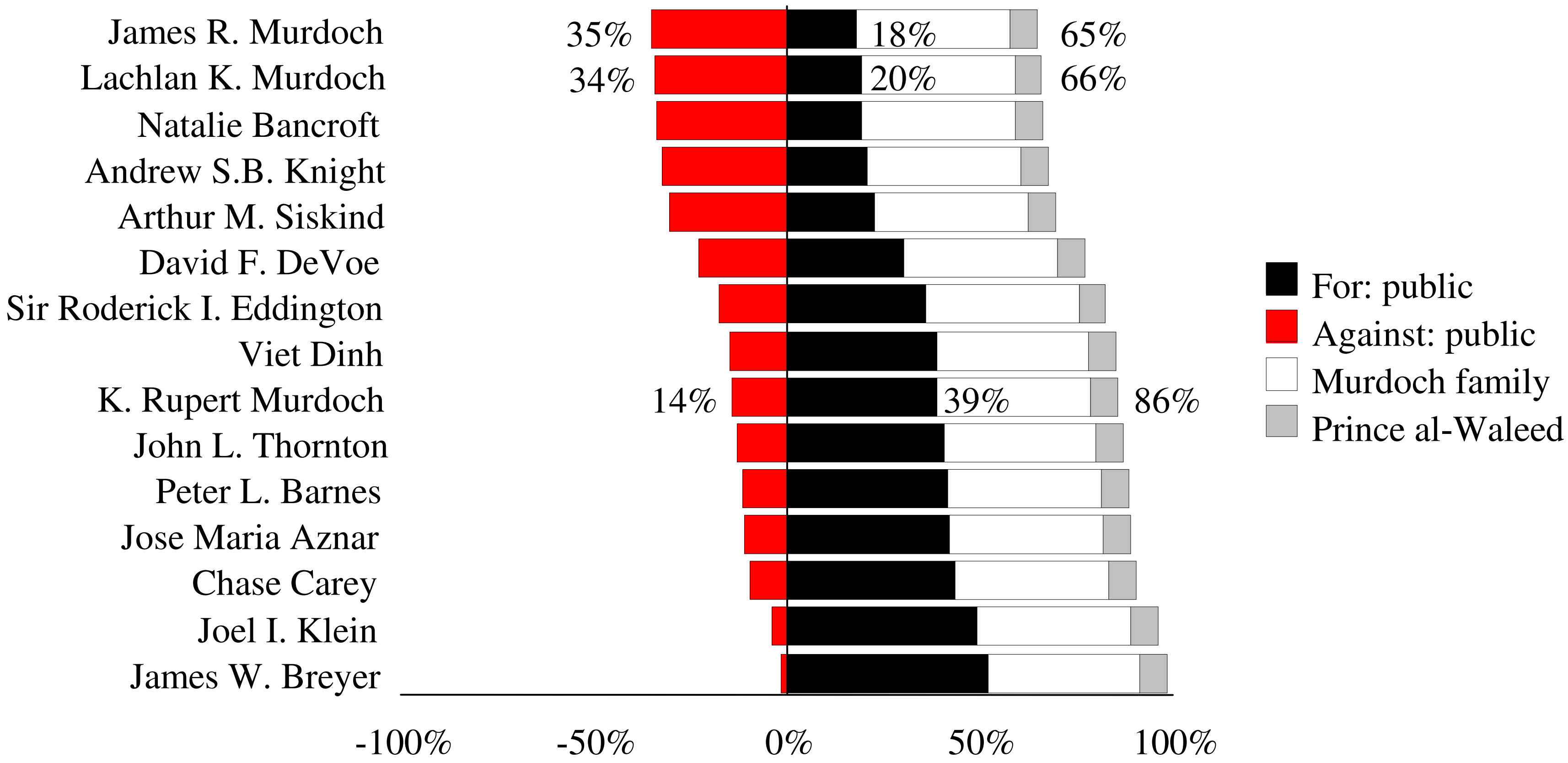
The voting tallies released on Monday reflect the level of discontent among shareholders, some of whom took the opportunity of Friday's meeting to voice their displeasure at the elder Mr. Murdoch and other directors.

Other directors whose independence has been questioned by shareholder advisory groups also drew significant opposition.

Example: News Corp. in 2011



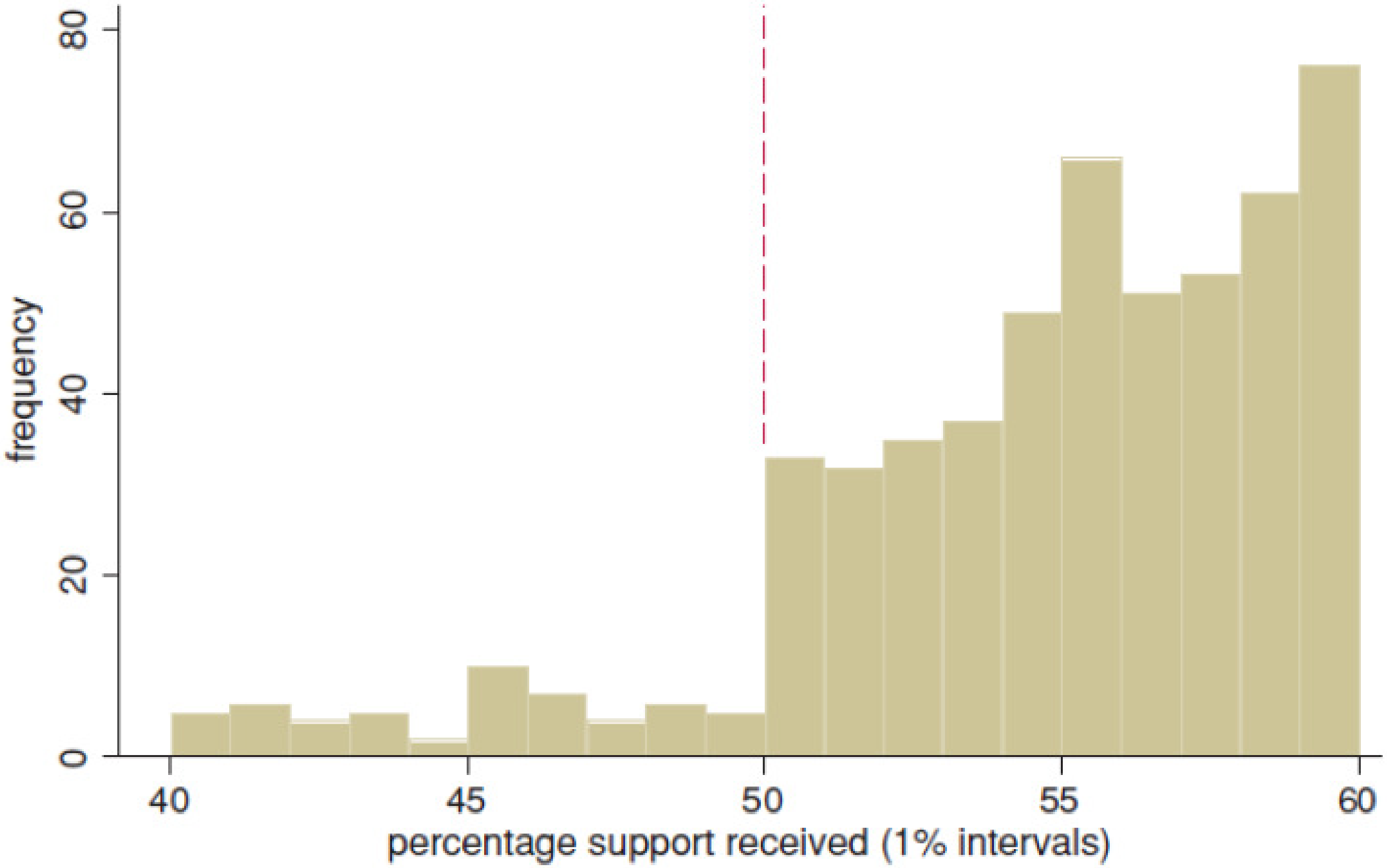
Example: News Corp. in 2011



Weakness of regulation and vote-counting technology

Management-initiated propoals

Frequency of vote outcomes around 50% passage threshhold



Source: Listokin (2008).

Over-voting

- 4% to 5% of all votes cast are illegitimate "over-votes"
  - Securities Transfer Assoc. in 2005 studied 341 companies, and found over-voting at all 341

- Will impact elections with a quorum requirement, such as bylaw amendments

Source: Smith (2012)

Proposals that appear to have passed only due to Over-votes

Meeting Date	Company	Description
6/11/2009	AgFeed Industries, Inc.	Approve Issuance of Shares for a Private Placement
10/6/2008	Allscripts Healthcare Solutions, Inc.	Amend Articles/Bylaws/Charter-Non-Routine
5/19/2009	Anadarko Petroleum Corporation	Declassify the Board of Directors
4/25/2008	Badger Meter, Inc.	Declassify the Board of Directors
4/27/2010	Banner Corporation	Increase Authorized Common Stock
6/18/2009	BioMimetic Therapeutics, Inc.	Approve Issuance of Shares for a Private Placement
9/13/2010	Bob Evans Farms, Inc.	Reduce Supermajority Vote Requirement
2/5/2008	Boise Inc.	Approve Merger Agreement
6/16/2009	Gran Tierra Energy Inc.	Increase Authorized Common Stock
5/6/2009	Heckmann Corporation	Increase Authorized Common Stock
4/5/2007	KB Home	Reduce Supermajority Vote Requirement
11/17/2008	Lancaster Colony Corporation	Permit Board to Amend Bylaws w/o Shrhldr Consent
9/17/2007	Mentor Corp.	Authorize New Class of Preferred Stock
5/15/2008	Meritage Homes Corporation	Authorize New Class of Preferred Stock
11/13/2008	Myriad Genetics, Inc.	Increase Authorized Common Stock
5/20/2009	Nash-Finch Company	Company-Specific–Organization-Related
5/13/2008	NiSource Inc.	Reduce Supermajority Vote Requirement
10/15/2008	Oilsands Quest Inc.	Increase Authorized Common Stock
4/22/2008	PACCAR Inc	Increase Authorized Common Stock
6/12/2008	RadNet, Inc.	Change State of Incorporation

Source: Smith (2012)

How accurate are corporate elections?

- Not very. +/- 5% is the consensus.
  - Inaccurate shareholder lists
  - Incomplete ballot distribution
  - Irregular vote counting by subcontractors

- Seems to be the consequence of an archaic system designed for a world of paper share ownership

- Important not only for identifying the “winner,” but for enabling shareholders’ signal to management to be read clearly

Source: Kahan and Rock (2007).

Manipulation of elections via "Empty voting"

One Borrowed Share, but One Very Real Vote

SOME investors seem to be taking advantage of a loophole in financial regulations to cast shareholder votes that are far out of proportion to the number of shares they actually own, a new academic study suggests.

The study, entitled "Vote Trading and Information Aggregation," has been circulating in academic circles for several months. Its authors are the finance professors Susan E. K. Christoffersen of McGill University in Montreal, Christopher C. Geczy and David K. Musto of the Wharton School of the University of Pennsylvania and Adam V. Reed of the University of North Carolina.

The authors describe a strategy that enables any investors, no matter how few of a company's shares they own, to profoundly affect the outcome of corporate resolutions that are put to a vote at the annual shareholder meeting. In effect, a shareholder can borrow a large number of shares for a nominal fee and use them to cast a corresponding number of votes.

As the study points out, the right to vote on a corporate resolution comes from possession, not ownership, of shares. That means a trader can borrow shares and thus be temporarily eligible to vote on corporate resolutions. The number of votes he can acquire is limited only by his ability to put up collateral — which is required to be 102 percent of the value of shares borrowed — and the number of shares available on the securities lending market. This market primarily serves those who wish to borrow shares in order to sell them short, but there is nothing to prevent its use by those whose motive is to influence the outcome of corporate votes.

As long as you have the collateral, borrowing shares is very inexpensive. The annual cost can be as low as 20 basis points, or two-tenths of a percentage point, on the cash that is put up. And because the borrower must hold the shares for just one day in order to have voting rights, the interest can be almost nothing. The cost to borrow $1 million of stock for one day, for example, could be less than $6, according to Professor Reed.

The professors are convinced that many traders are taking advantage of this loophole.

They reached this conclusion after studying what happens in the securities lending market immediately before and after the record dates for corporate votes. These are the dates when a shareholder needs to have possession of a stock in order to vote on a corporate resolution. The professors focused on 6,186 record dates for resolutions at publicly traded companies from November 1998 to October 1999.

At the annual meeting, possession trumps ownership.

They found that on the typical record date, there was a significant spike in the number of borrowed shares. And they found an almost-as-big decline in such shares, on average, the day after those record dates. In their opinion, the only plausible explanation is that traders borrowed shares solely to acquire votes. (A copy of the study is at papers.ssrn.com/sol3/papers.cfm?abstract-id=686026.)

The legal grounding for this practice is not entirely clear, according to the professors, as case law is in some respects ambiguous. But as a practical matter, Professor Reed said, there is "no direct legal impediment" to traders acquiring votes by borrowing shares.

Chester Spatt, chief economist at the Securities and Exchange Commission, said in an interview that it would be inappropriate for him to comment on whether the agency might be contemplating any regulatory changes to prevent investors from borrowing shares in order to influence corporate elections. "How voting works is at the heart of our proxy system," he said. "The professors are to be commended for helping to shine the spotlight on this important issue."

What effect could vote borrowing have on companies and their stock prices? There is no single answer, of course, because it depends on which investors are taking advantage of the loophole and what corporate policies they are supporting and opposing. Over the 12 months covered in the study, the professors found that a majority of vote borrowing was conducted by those who opposed management. But, the researchers also point out, there is no inherent reason that this should always be so. Indeed, corporate management could just as easily exploit this loophole to steer voting in its favor.

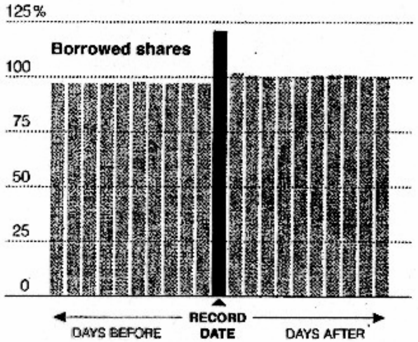
But it is clear that the opportunity to influence corporate elections exists. And it would be naïve to expect institutional investors never to take advantage of it. Hedge funds come to mind in this regard, because they have all the prerequisites: many of these funds have already become involved in corporate governance issues; they are large enough to take full advantage of the securities lending market; they are aggressive; and they are eager to find ways to eke out extra profit.

Shareholder democracy is an ideal that is perhaps rarely achieved under the best of circumstances. It's not likely to be attained if sophisticated investors can manipulate the outcome of corporate voting merely by borrowing the shares they need. □

Mark Hulbert is editor of The Hulbert Financial Digest, a service of MarketWatch. E-mail: strategy@nytimes.com.

Timely Borrowing

The number of a company's shares borrowed in the securities lending market often spikes on the record date — the day the shares must be held to vote on corporate resolutions — and drops back the next day.



Percentages of the average daily number of shares lent over the period from 10 days before the record date to 10 days after. Based on the average of 6,186 record dates at publicly traded companies from November 1998 to October 1999.

Sources: Susan E. K. Christoffersen, Christopher C. Geczy, David K. Musto, Adam V. Reed

The New York Times

Empty voting through the stock lending market

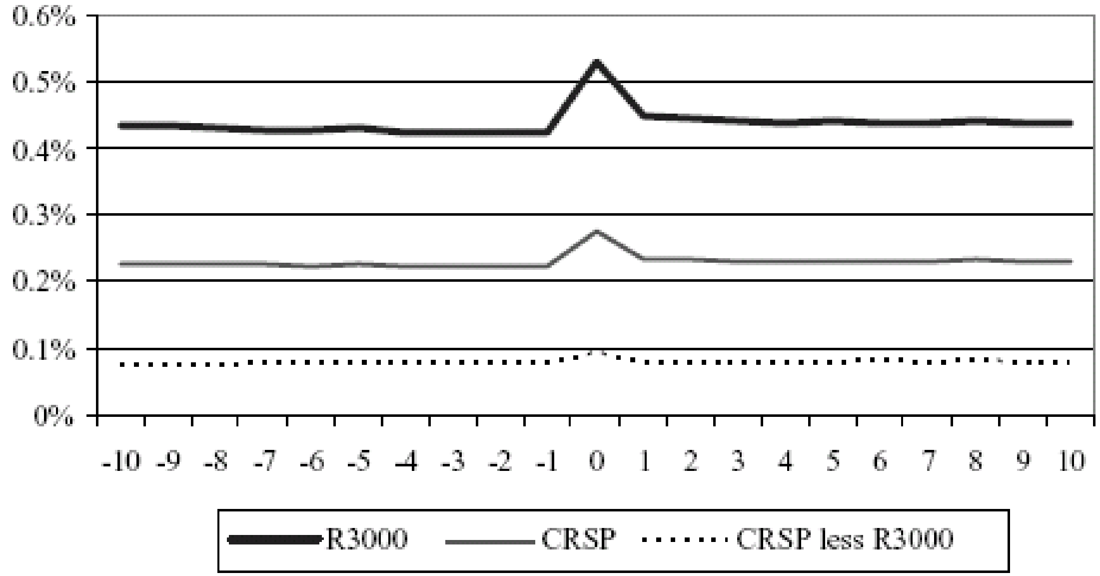
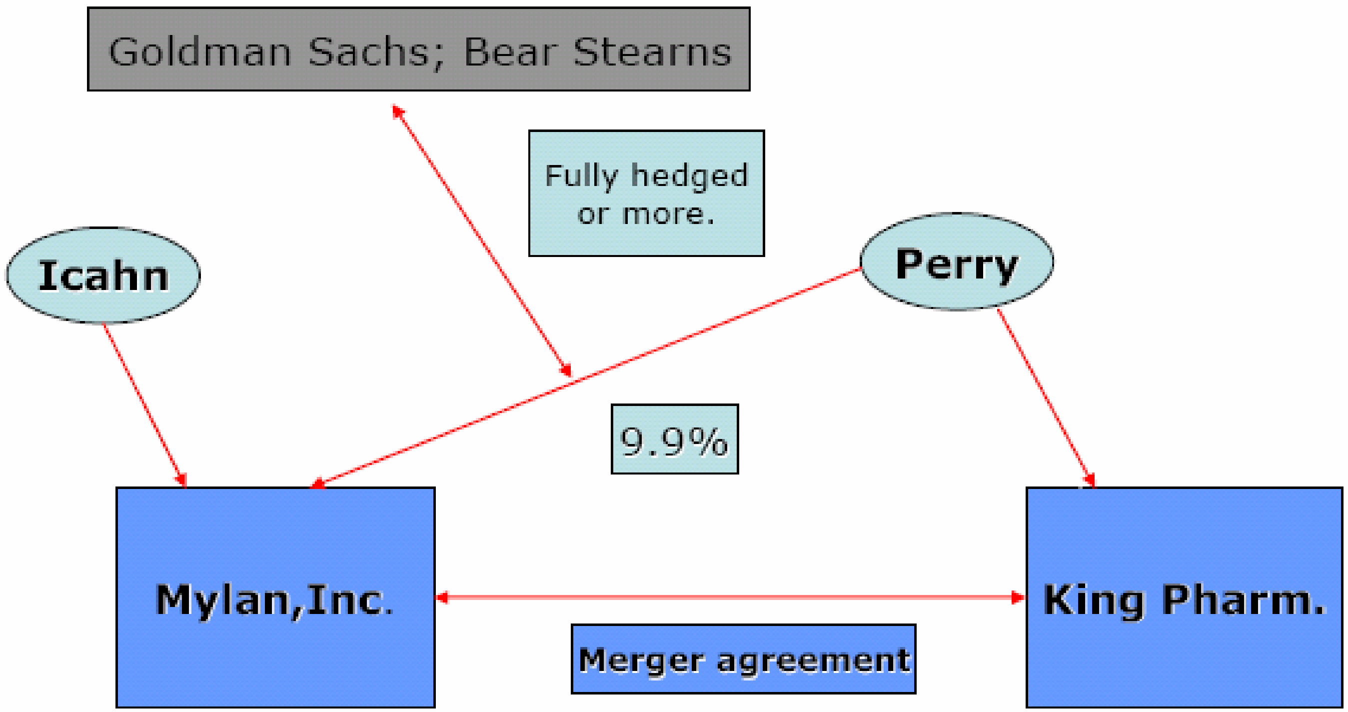


Figure 2. Loan market volume around voting record date. Loan date (where record date is 0) is on the horizontal axis, and shares loaned by our data provider, divided by shares outstanding, is on the vertical axis. The sample is 6,764 record dates of CRSP stocks from November 16, 1998 to October 15, 1999. The sample is broken into all shares in CRSP, all shares in the Russell 3000, and those shares in CRSP but not the Russell 3000.

Source: Christoffersen, Geczy, Musto and Reed (2007).

Empty voting: more complex example

Mylan Labs' 2004 bid for King Pharmaceuticals



Source: Kahan and Rock (2007).

Empty voting: observations

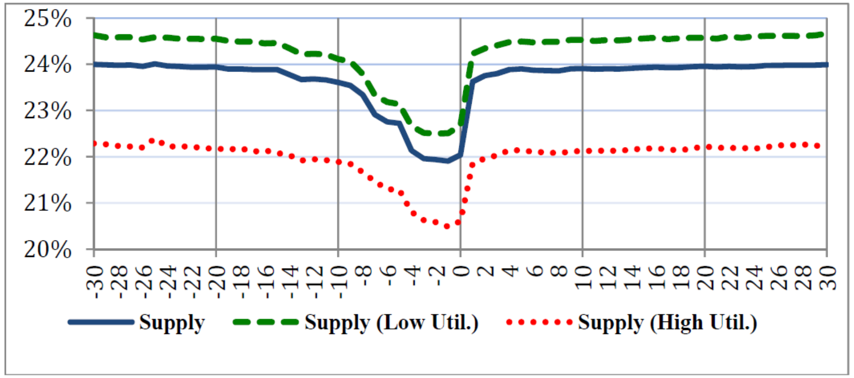
- Some of these strategies appear unbelievably cheap and low-risk.

- Some temporary owners of voting rights may vote against the company’s best interests.

- Remedy seems to be better disclosure, but that alone may not stop all moral hazard problems.

Empty voting: the backlash

- Many major institutional investors now recall their shares from the loan market prior to the ex-vote date



Source: Aggarwal, Saffi & Sturgess (2010)

Empty creditors

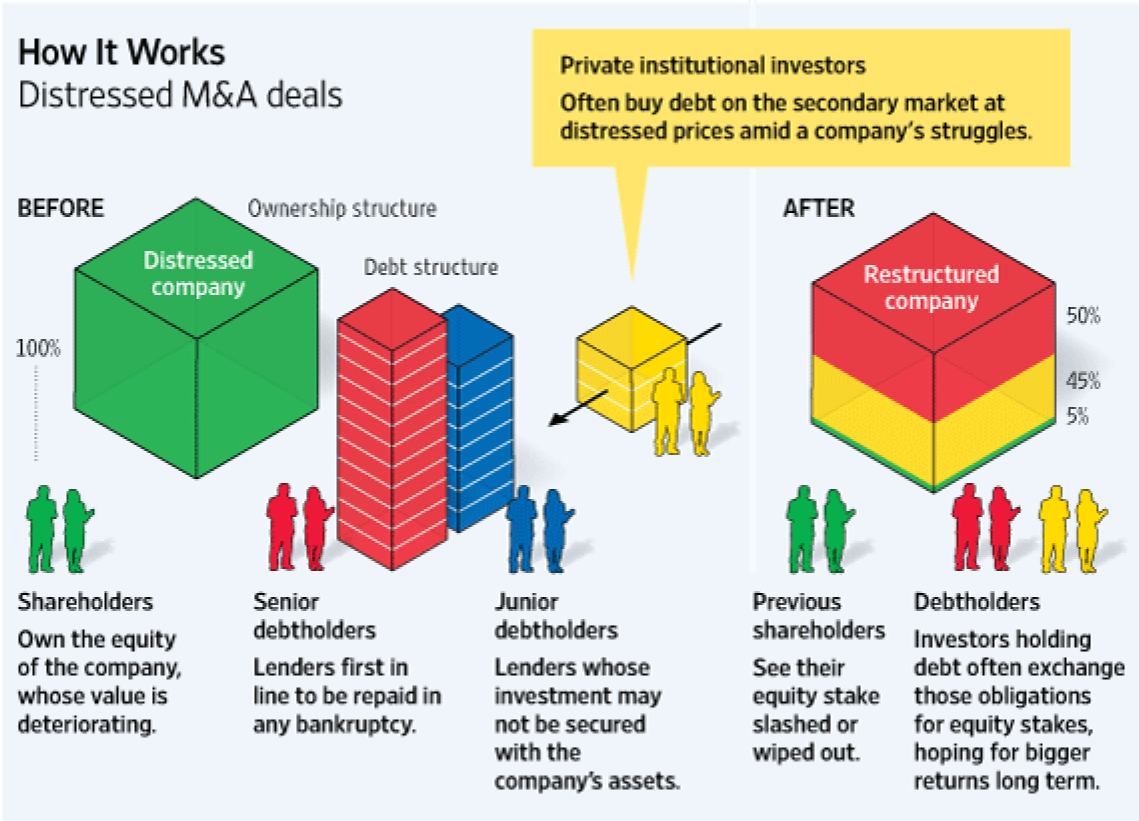
- Bondholders have voting rights in Chapter 11

- A bondholder can become an “empty creditor” by using CDS to protect cash flow rights

- In a distressed firm, bondholders can displace equity and take its voting power.
  - Buy distressed bonds / insure through CDS
  - Refuse to waive covenants; force a default
  - Inherit shares

Source: Subrahmanyam, Tang & Wang (2012)

Debt takeovers



Source: Wall Street Journal (2009)

Debt takeovers

THE WALL STREET JOURNAL.
WSJ.com

DEALS & DEAL MAKERS | August 11, 2009

Distressed Takeovers Soar

Deals Reach $84.4 Billion as M&A Bankers Flock to Bankruptcy Court

By MIKE SPECTOR and JEFFREY MCCRACKEN

The brutal recession is opening up the landscape to vulture investors as never before.

New data show that distressed-debt deals — in which creditors use their debt positions to seize ownership of troubled companies — are running close to double the pace of 2008. Some 140 of the deals have been struck during 2009, compared with 102 transactions for all of last year, according to data provider Dealogic. Those figures also include corporate takeovers, encompassing a wide array of transactions related to bankruptcies, restructurings, recapitalizations or liquidations.

The deals are valued at $84.4 billion altogether, dwarfing the $20 billion figure from 2008. And they involve companies from virtually every nook of the U.S. economy, from auto-parts maker Delphi Corp., to retailer Eddie Bauer and hotel chain Extended Stay America.

In many of these cases, debtholders aren't concerned about getting monthly payments, but rather using their debt positions to angle for ownership. It's the equivalent of a bank making a loan to a homeowner with the intent of foreclosing on a delinquent mortgage. Such strategies have been around for years and are known in financial circles as "loan to own" or "vulture" deals. But never have they occurred with such volume and velocity, say bankers and lawyers.

Today's lenders are "increasingly hedge funds who are thinking about a loan-to-own strategy," said Barry Ridings, the vice chairman of U.S. investment banking at Lazard Freres & Co. LLC. At troubled companies that can't pay their debts, boards find that ceding control to lenders is "the best way to maximize value," Mr. Ridings said.

Lessons learned

- Shareholder voting is much more confrontational than in the past
- Leads to real changes in boards, compensation, takeover defenses, and share values
- Can be very destabilizing