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Shareholder Activism: A Thoughtful Approach for Effective Engagement

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Article Highlights:

- Shareholder activists pursue two related goals: an increase in the value of their investment, and getting companies to adopt their views of governance and strategy.
- The board makes the final decisions and assumes responsibility for the outcomes.
- Activists prefer to engage through having a dialogue, not through a unilateral demand.

Shareholder activism has long carried a negative connotation among board members. The shareholder activist is too often seen as the gadfly shouting during the annual shareholders meeting, or the extremist group calling for divestment from certain countries.

This caricature is dangerously outdated. With multiple corporate scandals, the growing influence of proxy advisory firms and enhanced disclosure requirements from Sarbanes-Oxley, Dodd-Frank, and securities exchanges, shareholder activism has entered the mainstream. In 2010, 80% of companies surveyed by IRRC and ISS experienced at least one engagement from an activist investor. Activists include asset owners, such as Pershing Square Capital Management and Jana Partners, and asset managers, such as CalPERS, CalSTRS, and Vanguard, who push for corporate governance changes.

For the purposes of this discussion, shareholder activism means large shareholders who proactively engage the company and/or the board to accomplish their intended goals. Understood in this way, the topic can be addressed in an objective manner focused on positive outcomes. To help boards meet the growing phenomenon of activism, this overview covers the goals of activists, their main issues and methods, and how to build an effective engagement strategy.

<u>What Do Activists Want?</u>

Shareholder activists pursue two related goals: an increase in the value of their investment, and getting companies to adopt their views of governance and strategy. The first goal is the reason most activists purchase a company's shares. It is not rational for an activist investor to buy large blocks of shares primarily to agitate or bother management or the board. Second, regardless of the length of their investment horizon, activists want to have a more prominent part in the corporate governance conversation. They believe that they can contribute wisdom and insight that can help increase shareholder value.

Directors also take shareholder value as a primary objective. Whether a board will adopt an activist's view depends on three factors: whether the parties find common ground, whether the activist embarrasses the board, and whether adoption of the activist's position promotes shareholder value. While the views of how to achieve the objectives might initially diverge, the parties may often be closer in their objectives than they realize.

Despite similar goals, the board's interests and perspectives may differ from those of shareholders. The board makes the final decisions and assumes responsibility for the outcomes. Because of public scrutiny, directors must consider how their actions affect their reputations and personal liability.

<u>The Three Key Issues</u>

Within the rubric of these goals, activist investors consistently care about transparency and information on three issues:

1. <u>Executive Compensation</u>. The main areas of focus are the connection between pay and performance, guaranteed bonuses, and golden parachutes. Activists want to understand the reasoning behind compensation policies. They want to see that the policies align management's incentives with the pursuit of shareholder returns. Although say-on-pay votes are not binding, votes on compensation packages put the spotlight on executive performance and compensation committee members. In 2012, 55 out of about 2,300 say-on-pay votes failed, while in 2011, 37 out of about 2,300 such votes failed. Directors recognize that executive compensation is a critical issue. This is evident in improved CD&A's and performance-based compensation plans. Directors have made progress, yet realize that there exists an opportunity for improvement.

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2. Corporate Governance. Common topics of concern are director independence and board composition, majority voting and staggered boards, and sustainability and social issues. Activist investors care about governance structures and policies that do not increase shareholder returns or create unacceptable risks of reputational harm. So do board members and all investors. Directors are often aligned with activists regarding each of these concerns. Boards are now mostly independent, and composition has been positively affected by new trends in recruiting. Boards are paying more attention to social issues and staggered boards are less common. Many boards are adopting the practice of majority voting for directors.

3. Strategy. As with executive compensation and corporate governance, shareholders want to understand the underlying basis of the company's business model and strategy. Strategy becomes a point of conflict when the company's performance recommends against the existing strategy. Disagreements over strategy can lead to campaigns to replace board members and management. Directors understand that if the strategy isn't working, changes should be made. The executive team is better equipped than the board to understand the complexities of strategy formulation and execution. Because directors have a more limited view, they are purposefully responsible for oversight rather than the strategy and operations of the organization.

Which Works Better: Public or Private Engagement?

Activists prefer to engage through having a dialogue, not through a unilateral demand. Both asset managers and asset owners usually initiate an engagement through a letter or a telephone call. A proxy resolution rarely serves as the first communication. Likewise, boards prefer dialogue to a public conflict.

CalPERS, an outspoken advocate of corporate governance reform, has transformed its engagement strategy from partially public and partially private to entirely private. From 1999 to 2009, CalPERS publicly named 59 companies that it engaged for governance reform. During that same time period, the pension fund privately engaged 110 companies. In November 2010, CalPERS stopped publicly naming companies that it engages.

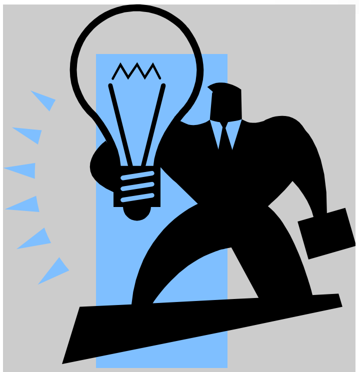
Whether the activist does its work in public or private, affects process and outcome. Although one might think that companies would act before being publicly embarrassed, embarrassment ironically seems to motivate companies to act. In 2010, Schulte Roth & Zabel and mergermarket found that companies see shareholder resolutions as a more effective tool than activists do. At the same time, activists see dialogue and negotiations as a more effective tool than companies do. Both parties believe that they cooperate in private in the majority of engagements.

How The Board Can Effectively Engage Activists

In building an effective approach to shareholder activism, board members should beware the natural tendency to become defensive in the face of criticism. Risk aversion and fear of the unknown can cause board members to reject what activists have to say. The standard approach leaves shareholder communication to management. That allows activists to determine the agenda and control the process with respect to the board. By contrast, proactive engagement helps the board to understand the activist's point of view and to find common ground. Although directors appropriately believe that operational matters are management's responsibility, engaging with activists touches upon the board's responsibilities and fiduciary duties.

Shareholder-board communications are relatively new. Thus, the board can benefit from working with management because management has more experience with activists. Directors should gather shareholder information from the CEO, CFO, and the investor relations group to help the board understand the activist and develop a specific plan of action. However, management's interests may diverge from activists' interests when activist recommendations conflict with existing corporate strategy and governance practice.

As a first step, the board should discuss when and how to engage with activists. A committee should be appointed to lead the communications. The governance committee is often a good candidate. The appointed committee and the CEO should catalog the concerns, prioritize them by significance and ripeness, and determine whether another committee should lead or support the communications. In taking these steps, the board, in collaboration with the senior leadership team, demonstrates its interest in understanding the concerns of activists and strengthening its leadership role in the corporate governance system.



Finally, an effective approach must incorporate legal considerations. For example, the board must take care to communicate within the parameters of Regulation FD. Regulation FD prohibits the board from giving material non-public information to only some shareholders. If material non-public information is disclosed to an activist, that information must be disclosed to all shareholders. When in doubt, seek the guidance of legal counsel. Similarly, the board should keep in mind its obligation to fulfill its fiduciary duties to all shareholders, not just the activists. The interests of activists and other shareholders might conflict where an activist seeks changes that destroy shareholder value. An activist who misapplies research findings on board structure might ask for changes that do not fit that company.

Conclusion

Combined with an increasing recognition that shareholder activism is here to stay, boards are becoming more proactive in addressing shareholder concerns. Boards and activists are learning how to navigate this new environment of heightened regulation and public scrutiny. Within this context, the board has a choice: proactively communicate with activists, or let the activists take the leadership role. The choice will shape the board's relationship with shareholder activists. Moreover, the choice will affect how effectively the board takes on the issues that activists target.

All parties aspire to enhance shareholder value. After careful consideration, the board will sometimes promote the company's view rather than agree with the activist's view. Nevertheless, when people get together and understand each other, brave leadership can result in improved practices and better outcomes for everyone.

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Douglas Y. Park, is at a Partner at Rimon, PC, in Palo Alto, Calfironia. He specializes in solving problems in corporate governance, corporate and securities law, and strategy. A recognized authority on corporate governance, Doug has been quoted in Time.com; Reuters; Agenda, a Financial Times service for corporate directors; Corporate Secretary, and other publications. Doug received his J.D. from the University of Michigan Law School, his Ph.D. in Strategy and Organization from the Stanford Graduate School of Business, and his B.A. magna cum laude with highest honors in Sociology from Harvard College.

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