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Recent developments suggest the desirability of completely rethinking the mindset with which many companies react to shareholder activist campaigns. This article examines these developments and outlines steps that boards and management should take to be ready to respond.
Public companies face an increasingly complex corporate governance environment. The catalyst for much of this complexity is a growing group of hedge fund and other “long” investors considered “activists.” Key characteristics of an activist investor include the:

- Financial capacity to accumulate a meaningful economic position in a target (through shares and/or derivatives).
- Ability to identify changes at targeted companies that appeal to large numbers of more traditional institutional investors.
- Ability to attract interest from other activist investors and the financial media.

In recent years, these activists have been able to obtain support from a growing number of pension fund, mutual fund and other traditional institutional investors. Indeed, traditional institutional investors now sometimes reach out to activists to encourage them to target companies in which the traditional investors own positions. These traditional investors now also invest in activist hedge funds, increasing their size and enabling the activists to target larger public companies.

Corporate governance complexity is not, however, caused by activists alone. Boards of directors and management teams remain, as they have been for many years, under pressure from proxy advisory firms such as Institutional Shareholder Services, Inc. (ISS) to change company anti-takeover protections (to the extent not already dismantled), establish independent board chairs and take other so called “good governance” actions. Boards also need to respond to concerns raised by investors on societal issues such as executive compensation, carbon utilization, board diversity, political contributions, government relations expenditures and similar matters.

This article examines:

- The growing influence of shareholders on the management of public companies.
- The impact of shareholder engagement on shareholder activism in the 2013 proxy season.
- The interplay between governance and activism.
- The changing role of proxy advisory firms.
- The implications of increasing shareholder activism for public companies.
- Steps boards and management should take to be better prepared for activist campaigns.

**GROWING SHAREHOLDER INFLUENCE**

The ability and willingness of shareholders to influence the management and affairs of companies has been steadily increasing for more than a decade. The factors that have increased, and that continue to increase, the influence of shareholders include:

- The success of shareholder proposals to dismantle classified boards and other takeover protections, beginning in the mid-2000s.
- The continued use of shareholder proposals in more recent years to pressure boards to implement other governance measures, including majority voting, elimination of supermajority approval requirements and the rights of shareholders to call special meetings or act by written consent.
- The policies of proxy advisory firms, including ISS, to recommend withhold votes for directors at companies that fail to implement successful shareholder proposals.
- The advent of universal say on pay voting.
- The growing success of shareholder proposals calling for proxy access.

These initiatives have been championed as examples of “good governance,” often with too little examination of the fundamental question of whether they contribute to the creation of enhanced long-term value. There are credible academic studies that suggest that they often do not (for example, see Thomas Bates, David Becher and Michael Lemmon, *Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control*, 87 J. FIN. ECON. 656-677 (2008).)

The playing field has changed fundamentally and the changes have resulted in greater influence for shareholders. Boards and management must recognize this reality when engaging with shareholders generally, and when preparing for and responding to a particular activist campaign. Unlike hostile takeovers, activist campaigns can have a wide range of possible outcomes, with varying degrees of disruption. The key is to realistically assess the situation to obtain the best outcome possible under the circumstances for all shareholders.

**IMPACT OF SHAREHOLDER ENGAGEMENT ON SHAREHOLDER ACTIVISM**

Notably, the 2013 proxy season was marked by a large number of activist campaigns and a trend for activists to target significantly larger companies, including Apple, JPMorgan Chase, Dell, Sony, P&G, Hess and PepsiCo.

The results of the 2013 proxy season, however, demonstrate that active and thoughtful shareholder engagement on an ongoing basis can provide significant benefits for boards and management. For example, US companies generally had better results on say on pay votes in 2013 as compared to 2012. In 2013, the S&P 500 companies had a lower rate of ISS negative recommendations and greater success in receiving at least 70% of votes cast than in 2012. Fewer large companies received less than a majority of votes cast, with only five US S&P 500 companies in 2013, as opposed to ten in 2012.

The primary reason for this improvement is that larger companies have continued to move up the learning curve in terms of effectively engaging with shareholders, understanding their concerns, and addressing these concerns through changes in compensation practices and clearer compensation disclosure. In addition, companies have become more adept at effective off-season communications with:

- Shareholders, from whom the company can obtain feedback on the most recent voting results, and on expectations and concerns for the coming year.
- Proxy advisory firms, to address any misconceptions evident from the prior vote and to discuss issues that may be relevant to the next year’s vote.
In addition, the 2013 proxy season saw a number of management victories in contentious vote situations. The most prominent example arose from a shareholder proposal to separate the CEO and chair roles at JPMorgan. Based on results disclosed by JPMorgan in a Form 8-K report, the proposal received only approximately 32% of the votes cast, despite the endorsement of ISS and Glass Lewis & Co. This was down from over 40% of votes cast on a similar proposal in 2012. JPMorgan’s success in defeating this measure demonstrates the company’s ability to defend its chosen governance structure to its shareholders by making appropriate efforts to explain its choice to shareholders rather than acquiescing to the demands of activist shareholders or to purported “best practices.”

INTERPLAY BETWEEN GOVERNANCE AND ACTIVISM

The largest institutional investors increasingly are devoting substantial resources to making proxy voting decisions. This means that they are relying less on proxy advisory firms and more on their internal teams. As a result, it is more important than ever to understand the factors that influence the voting decisions of the largest institutions, which often control more than 20% of the votes at public companies.

One important consideration for all institutional investors in making their voting decisions is their assessment of whether they believe a particular management team and board is sufficiently committed to advancing shareholder interests generally. This focus can make a company’s governance profile a relevant and even important consideration in whether institutional investors support an activist proposal or board slate, a say on pay vote or other governance matter.

The potential significance of the governance profile has several consequences for public companies, including the need to:

- **Carefully consider any implementation of governance measures.** Decisions about the implementation of “good governance” actions should take into account both the company’s overall governance profile and the potential harm a failure to implement could have on shareholders’ perceptions of the company’s overall commitment to shareholder interests. This does not mean that every “good governance” measure should be implemented at every company. It only means that decisions on what to do should take into account the potential significance of that item to the company’s overall governance profile.

- **Articulately defend decisions on governance initiatives.** Companies need to articulately defend their decisions not to implement particular governance initiatives with arguments grounded in the creation of shareholder value. As discussed above, JPMorgan handily defeated a proposal to separate the CEO and board chair positions because they effectively articulated the value of maintaining the joint CEO/chair position, the effectiveness of their lead director role in protecting shareholder interests and their strong performance under the existing structure. This is a success that can be replicated by others.

- **Regularly communicate with investors.** It is important for companies to have regular communications with the largest institutional investors and focus those communications so that they are meaningful to the institutions’ voting decisions. Often these decisions will hinge not on whether a company’s return on equity is within the top quartile, but on the investors’ belief that the company is in the top quartile with respect to the quality of the management team and its commitment to shareholder interests. Large institutions make decisions on their perception of the management and board leadership as well as corporate performance. These perceptions are developed in face-to-face meetings and phone calls, ideally over a period of years before any activist appears on the scene. As a result, communications, focused on the topics of interest to these investors, are critically important.

The interplay between governance and institutional investor voting decisions is not new. Proxy advisory firms have often applied mechanical tests to assess the degree of “good governance” at public companies and used the results of these tests in their voting recommendations. What is new, or perhaps newly realized, is the extent to which large investors are willing to consider governance status on a company-by-company basis independent of proxy advisory firm recommendations and the corresponding importance of a company being able effectively to defend its case using arguments these institutions find persuasive.

CHANGING ROLE OF PROXY ADVISORY FIRMS

Interestingly, increased activism also seems to have contributed to the apparent reduction in the impact of ISS and other proxy advisory firm recommendations in visible contested situations. The limited impact of ISS on both the JPMorgan shareholder proposal to separate the CEO and chair roles and the Dell going private vote are examples of the increased commitment by investors to make their own decisions on important corporate votes, using proxy advisory firms only as a resource, and giving due consideration to persuasive and focused communications by the target companies. This is a positive trend.

The influence of proxy advisory firms is likely to be reduced further in coming years by some combination of regulations applied to proxy advisory firms or their clients and the threat of such regulation. The increase in proxy advisory firm influence was greatly facilitated by SEC staff interpretive letters suggesting that registered investment advisers might discharge their fiduciary duty to advisory clients in voting by following the recommendations of an independent advisory firm.

More recently, as the influence of proxy advisory firms has grown and questions have been raised about their conflicts and
the thoughtfulness of their analyses and recommendations, commentators, including some SEC Commissioners, have suggested that there is an overreliance by investment advisers on the recommendations of proxy advisory firms, and that this is an area that should be addressed by regulation.

Already major investors such as Vanguard, Blackrock and others are increasing the internal resources they devote to establishing their own general voting guidelines and the attention they devote to voting decisions on high visibility votes. They are also publicly encouraging companies to engage with them directly rather than focusing solely on the proxy advisory firms. In many situations, these investors will use proxy advisory recommendations and data as input but will ultimately make their own decisions.

Proxy advisory firms are increasing their attention to their own conflicts of interest and allocating more resources to analyzing proxies and making recommendations. The quality of their analyses, however, remains highly uneven. They demonstrate a bias in favor of insurgents seeking minority board representation, and they fail to adequately correct even obvious errors in information published as part of their voting recommendations.

Companies can, and should, point out flaws in the reasoning or factual underpinnings of activist proposals. A company’s credibility will be enhanced if it responds to the activist in a measured, fact-based manner.

Greater levels of shareholder engagement by public companies in recent years, spurred in part by the advent of universal say on pay voting, has further helped companies develop shareholder relationships and lines of communication that can reduce the rote reliance by shareholders on proxy advisory firm recommendations.

**IMPLICATIONS FOR PUBLIC COMPANIES**

Recent developments suggest the desirability of completely rethinking the mindset with which many companies react to activist situations. Companies can achieve better outcomes if they avoid starting from a mindset that activists and their ideas are necessarily “bad” and must be resisted in the same way that a company would resist an uneconomic and coercive tender offer. Applying the vocabulary and mindset of 1980s takeovers to today’s activists is likely to be counterproductive.

In this environment, companies and their boards should not reflexively dismiss proposals put forward by activists. Just as reflexive resistance to unsolicited takeover proposals has faded since the 1980s, reflexive resistance should not be the default response to activist proposals. In many cases, a board will conclude that an activist proposal is not optimal, and is perhaps even significantly suboptimal, for value creation. But the case for this position will be better understood and more readily accepted by shareholders if it reflects a considered evaluation of the activist proposal and alternatives for value creation.

For public companies, it does not mean that there is a change in the duty of directors to manage companies in the way directors think best, even when that way is different than some shareholders (or most shareholders) might prefer. Directors should listen to the views of shareholders, but must direct the company in the manner they believe to be in the company’s best interests. In this sense, nothing has changed. It also does not mean that companies should do less to prepare to respond to activist campaigns or respond less vigorously or forcefully to proposals that the board concludes are not in the company’s best interests.

What it does mean is that dealing with activist campaigns should be informed by a clear recognition that an activist with a relatively small direct holding may well have the support of many, less vocal shareholders. The board should also recognize that if the company has an activist problem, it may also have a broader shareholder problem. Understanding the scope and source of that problem is central to effectively addressing any activist campaign. Preventing that problem should be an objective of every public company today.

The increased activism among shareholders, along with the trends discussed above, has made it more difficult to “just say no” to an activist campaign. It also makes it ineffective to base a response to activist shareholders on generalizations about short-term versus long-term value creation. In today’s environment, many investors evaluate their positions regularly, even daily, and arguments about “short-termism,” whatever their economic merits, will not be persuasive to many investors.

Instead, companies must present a clear case that their approach will create superior value over some near- to medium-term time horizon. This sometimes can be accomplished through better articulation of the long-term effects of a company’s current strategy, because the current stock price should reflect the market’s assessment of the present value of those long-term effects.

Additionally, companies can, and should, point out flaws in the reasoning or factual underpinnings of activist proposals.
A company’s credibility will be enhanced if it responds to the activist in a measured, fact-based manner. Regular review by the board of the company’s strategic options will put the company in a better position to respond quickly and decisively to show shareholders that the board already has considered the proposal in question and explain why they rejected it.

**PREPARING FOR ACTIVIST CAMPAIGNS**

A company that is targeted by activists is in a far better position to effectively respond if the company has taken appropriate preparatory steps. For example, companies should:

- **Focus intensely and regularly on a consistent program of shareholder communications.**
- **Identify a small team responsible for shareholder engagement and responding to shareholder proposals and initiatives.**
- **Prepare the board and management to respond to shareholder initiatives, including by assessing at least annually the company’s attractiveness as a target for shareholder initiatives based on the company’s most recent performance and trends in shareholder activism.**

Companies should also promote changes in the company/investor dynamic that focus on shareholder value creation and investor responsibility for their voting decisions.

**ENGAGE SHAREHOLDERS**

Effective two-way communications with investors outside of a crisis or activist situation is more important than ever. While active shareholder engagement requires significant senior management (and sometimes board) time and attention, the results of the 2013 proxy season have confirmed that companies reap significant benefits from their regular commitment of these resources when an activist or other contentious situation does arise.

In particular, companies should:

- **Engage regularly with shareholders.** Designated executives, most often some combination of the CEO, CFO and head of investor relations (IR), should be able to communicate the company’s plans for value creation, and the fact that value creation is the focus of board efforts, to a wide range of shareholders. These officers also need to be able to communicate recommendations, as well as criticisms of management and the board back to both groups, without watering down shareholder concerns. It is as important to listen as it is to advocate.
- **Keep close track of who the shareholders are and any changes in shareholder constituency.** Significant changes in a company’s shareholder base can be an early warning sign of possible discontent or instability, both of which are magnets for activist campaigns.
- **Focus on clarity and consistency when communicating corporate strategy.** Recognize that inconsistent or inartfully worded statements and positions may be used against the company by shareholders agitating for change.
- **Respond actively and directly about earnings shortfalls or other adverse business developments.** It is better to have open channels of communication than to be seen as defensive or evasive. Relying on Regulation FD to avoid deeply engaging with shareholders is rarely necessary. The company’s public disclosure should be sufficiently detailed and thoughtful to allow productive shareholder dialogue to occur without raising selective disclosure issues.

- **Understand how the major shareholders make proxy voting decisions.** Increasingly, large institutions are moving away from strict adherence to proxy advisory firms such as ISS and towards an internal process that incorporates ISS or other reports into a broader decision-making process, which includes input from the company. Shareholder engagement outside of a crisis situation can lay the groundwork for an investor to make informed voting decisions that do not necessarily align with ISS’s recommendations.

**IDENTIFY A SMALL TEAM**

Shareholder initiatives are generally accompanied by highly active public relations (PR) and IR campaigns, often anchored by highly detailed proposals for changes in the business. It is important for the company to act quickly and efficiently in responding to these initiatives, so that management feel comfortable, even compelled, to bring criticisms to the board, even when shareholders are critical of board composition, qualifications or actions.

Boards should regularly receive updates from management on their contacts with shareholders and any issues and concerns being raised in those contacts. It is important that management feel comfortable, even compelled, to bring criticisms to the board, even when shareholders are critical of board composition, qualifications or actions.

The core team should meet periodically to:

- Review current trends in activism.
- Prepare recommendations for the company’s possible responses to various potential shareholder initiatives.

It is a common mistake to underestimate the amount of management time and energy it will take to address an activist campaign, whether it is a fight for board seats, a shareholder proposal or a merger vote. Keeping the team small will permit focused action and response while leaving most of the
management team available to concentrate on running the business.

Companies should take into account the amount of management time and energy that will be consumed in deciding whether to resist or settle an activist proposal. Companies also should consider the potentially adverse effects of a long campaign of visible, vitriolic criticism of the company and its leadership. These can over time affect market perceptions, whether fairly or unfairly.

**PREPARE THE BOARD OF DIRECTORS**

The targets of shareholder initiatives are not chosen randomly. The shareholders who initiate campaigns select targets that they perceive as vulnerable to whatever positions they assert. The positions asserted are not always the best paths to creation of enduring shareholder value, but they often can be anticipated, as can likely shareholder tactics. This means that companies can take steps to prepare for potential activist campaigns, which can lead to a more effective, timely response.

In preparing for activist campaigns, companies should:

- **Conduct regular strategic review of business opportunities and challenges.** Most companies today engage in a regular process of strategic review considering medium- and longer-term business opportunities and challenges. These reviews are important to allow directors to formulate a common understanding of company business objectives and priorities. That understanding is often key when it comes time to respond to a shareholder proposal.

- **Evaluate alternative financial and business strategies for value enhancement.** One of the fundamental messages of this new era of shareholder engagement is that shareholders expect directors to actively evaluate alternative financial and business strategies for value enhancement. Board review of business opportunities and challenges should include specific consideration of the kinds of positions activists might take, particularly as to matters such as board composition, management changes, dividend/share repurchase policy, possible divestitures and spin-offs, sale of the company or other business changes.

- **Engage outside financial and legal advisors.** Outside financial and legal advisors can provide useful perspectives on possible activist positions. Many financial advisors now have groups focused on advising companies that are dealing with activists, and these advisors can identify actions that an activist might promote at a particular company. These insights can help the board and management to respond thoughtfully and quickly to proposals raised by an activist.

- **Brief directors periodically on their fiduciary duties in the context of acquisitions and shareholder initiatives.** It is important for directors to understand that they have a duty to act in what they believe to be the best interests of the company and its shareholders, even when that action is not supported by a majority of shareholders.

- **Educate boards on the interplay between governance, compensation and board composition issues and shareholder activism.** Regular attention to changing market trends in these areas is important. It is also important for a board to understand that the particular circumstances of its
company may fully justify a deviation from these trends, in which case the company should be prepared to explain to shareholders clearly and in detail the board’s decision and the alternatives it has considered.

- **Consider having a lead director, a committee chair or a small number of other directors involved in meetings with shareholders.** In some circumstances it may be useful for one or more directors to communicate the board’s commitment to enhancing shareholder returns and to hear firsthand any shareholder concerns. Of course, this approach will not be appropriate for every company or every circumstance. Some companies, however, may benefit from this kind of engagement.

- **Emphasize consistency and clarity in corporate communications.** It is essential that directors understand the importance of being clear and consistent when communicating with the public. In particular, directors should not speak to the media or investors except in accordance with a specific, approved plan.

- **Provide boards with periodic reports on management’s engagement with and issues raised by shareholders.** Unfortunately, traditional institutional shareholders are often reluctant to raise directly with members of management their criticisms of management policies, so an absence of overt complaints is not necessarily proof of shareholder satisfaction.

**PROMOTE CHANGE**

Public companies, investors, regulators and academics need to do more to develop and promote a board/shareholder dynamic that facilitates mutual understanding and consistently enhances shareholder value.

On the company side, this means that the board needs to be thoughtful about ensuring that shareholders understand its commitment to shareholder value creation and the governance and other decisions made to promote that value creation. On the investor side, it means considering the value effects of governance and substantive initiatives and giving fair, thoughtful consideration of incumbent board and management views. In particular, both sides should work to promote change in the following ways:

- **Focus the governance debate on what is actually best for shareholder value creation.** This should be the touchstone of all efforts by boards and shareholders, but too often certain governance actions (such as splitting the roles of CEO and chair) are promoted without considering whether they are likely to create (or could even destroy) value at that particular company.

- **Encourage a debate about the seemingly automatic position of ISS and some institutional investors to adopt a “what’s the harm” attitude towards minority board representation for activists.** In some circumstances there can be real harm in removing existing directors and adding new directors who may create discord and not make a positive contribution to shareholder value creation.

- **Encourage investors to delegate less authority to proxy advisory firms.** This requires effort and expense by investors, but firms managing money for others should be expected to devote appropriate attention to voting decisions. Investors who subscribe to ISS also can encourage ISS to improve the quality of its recommendations and its focus on shareholder value creation. A history of company outreach and engagement can help an institutional investor establish a basis to justify a deviation from ISS’s recommendation in a particular instance.

**THE ROAD AHEAD**

The pendulum of shareholder empowerment has swung sharply away from earlier days of substantial deference to the board. That swing has not stopped, and there is a need to look forward to anticipate the environment companies will face in 2014 and beyond. Although the simplicity of strident calls for the defeat of activist proposals on the basis that they reflect short-term investment horizons have some significant appeal, it often will not be a winning strategy. Companies will be better served by:

- Recognizing the new shareholder dynamic.
- Staying in close touch with their major shareholders.
- Utilizing a more sophisticated understanding of the new dynamic to achieve better outcomes in activist campaigns.

Companies should also work to change the shareholder dynamic so that it is less reflexively supportive of activist positions and more consistently aligned with the creation of enduring shareholder value.