Adjusting to Shareholder Activism

Active Shareholders are the New Normal, Placing a Premium on Management Preparedness, Board Awareness and Ongoing Shareholder Engagement for Public Companies

SUMMARY
The results of the 2013 proxy season and other recent corporate governance developments have demonstrated that boards and management teams should thoughtfully assess their approach to dealing with hedge funds and other “long” investors that are considered “activist.” Responding effectively to these activist shareholders in today’s environment requires more continuous engagement with shareholders, a recognition of the broad support given to many activist campaigns by traditional investors and advance preparation.

The universe of “activist” shareholders has expanded and their supporters more so. There is a broad spectrum of activist behavior that many traditional institutional investors – mutual funds, pension funds, sovereign wealth funds and others – increasingly see as essential to enhancing their returns. This trend is reflected both in the increasing investor inflow into funds managed by hedge fund activists, which has permitted them to initiate action at larger companies, and in the increased voting support traditional institutional investors give to activist campaigns. To a greater or lesser extent, today many institutional investors are activist investors. These developments have highlighted the importance of management preparedness, board awareness and active, regular investor engagement on issues of importance to investors.

BACKGROUND
The ability and willingness of shareholders to influence the management and affairs of corporations has been steadily increasing for more than a decade. It began with the success of shareholder proposals to
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dismantle classified boards and other takeover protections and continued with the use of shareholder
proposals to pressure boards to adopt majority voting and other governance measures, combined with
the policy of ISS to recommend withhold votes for directors at companies that fail to implement successful
shareholder proposals, the advent of universal say-on-pay votes and the move toward proxy access.
These initiatives have been championed as examples of “good governance”, often with too little
examination of the fundamental question: do they contribute to the creation of enhanced long-term value?
There are credible academic studies that suggest that they do not.

The playing field has changed fundamentally and the changes have resulted in greater influence for
shareholders. Boards and managements 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 multiplicity of possible outcomes, with varying degrees of
disruption. The key is to realistically assess the situation so as to obtain the best outcome possible under
the circumstances.

Fortunately, the results of the 2013 proxy season – for example, the improved say-on-pay results at large-
cap companies and a number of management victories in contentious vote situations¹ – demonstrate that
active and thoughtful shareholder engagement on an ongoing basis provides significant benefits for
boards and management in navigating this new environment.

IMPLICATIONS FOR CORPORATE CLIENTS

Recent developments suggest the desirability of rethinking – completely – the mindset with which many
companies approach activist situations. We believe 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 1980’s takeovers to today’s activists is likely to be counterproductive.

In this environment, companies and their boards should not reflexively respond dismissively to proposals
put forward by activists. Just as reflexive resistance to unsolicited takeover proposals has faded since
the 1980’s, reflexive resistance should not be the default response to activist proposals. In many cases
to be sure, 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.

¹ For a discussion of the results of the 2013 proxy season, see our publication, dated July 2, 2013,
etitled “2013 Proxy Season Review.” For a discussion of the positive impact of company
engagement efforts in the case of the shareholder proposal to separate the CEO and chair roles at
JPMorgan Chase, see our publication, dated May 21, 2013, entitled “Shareholder Proposal to
Separate Roles of Chair and CEO Fails at JPMorgan by a Wide Margin.”

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August 22, 2013
What does this mean 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. But it does mean 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 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.

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 vs. 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. The company’s credibility will be enhanced if any response to the activist is handled in a measured, fact-based manner. Regular review by the board of directors of the company’s strategic options will put the company in the 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.

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

Interestingly, increased activism also probably 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
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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.

If a company is targeted by activists, the company will be in a far better position to effectively respond if
the company has taken appropriate preparatory steps. For example, as discussed further in the following
sections, we recommend that clients:

- 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; and
- prepare the board of directors 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.

We also recommend that clients promote changes in the company – investor dynamic that focus on value
creation and investor responsibility for their voting decisions. Specific recommended actions are
discussed below.

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 2013 proxy season has confirmed that companies reap
significant benefits from the commitment of these resources when an activist or other contentious
situation does arise.

- Regular engagement with shareholders is critical. Designated executives, most often some
  combination of the CEO, CFO and head of investor relations, 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 your shareholders are and changes in your shareholder constituency.
  Significant changes in your 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 for communicating corporate strategy. Recognize that
  inconsistent or inartfully worded statements and positions may be used against the company by
  shareholders agitating for change.
- Deal actively and directly with 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 fruitful
  shareholder dialogue to occur without raising selective disclosure issues.
- Understand how your major shareholders make proxy voting decisions. Increasingly, large
  institutions are moving away from strict adherence to 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 PR/IR campaigns, often anchored by highly detailed proposals for changes in the business, and it is important for the company to act quickly and efficiently in responding, so that management is not unduly distracted from operating the business.

- Identify a small group of managers, probably three to five, who will lead the effort. This group will often include internal financial, strategic, PR/IR and legal personnel, working with outside financial, PR/IR, legal and proxy solicitation advisors, as necessary.
- Particular internal or external expertise (e.g., accounting or executive compensation) may be required to address specific shareholder concerns.
- The core team should meet periodically to review current trends in activism and prepare recommendations for the company’s possible communications responses to various possible shareholder initiatives.

Prepare the Board of Directors

Shareholder initiatives are not randomly targeted. The shareholders who initiate a campaign select targets that they perceive as vulnerable to whatever position the activist asserts. 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. Preparation can lead to a more effective, timely response.

- 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.
- Brief directors periodically on their fiduciary duties in the context of acquisitions and shareholder initiatives as well as what positions a shareholder activist might take, particularly as to matters such as board composition, management changes, dividend/share repurchase policy, possible divestitures or spin offs, sale of the company or other business changes. Outside advisors can provide a useful perspective on possible activist positions. 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.
- In some circumstances, a company should consider having a lead director, a committee chair or a small number of other directors involved in meetings with shareholders to communicate the board of director’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. But we believe some companies will benefit from this kind of engagement.
- 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’s also important for boards to understand that the particular circumstances of their 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 decision and the alternatives it has considered.
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Emphasize to directors the importance of consistency and clarity in corporate communications, including the importance of not having directors speaking 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

Although this publication focuses on practical advice for corporations, we believe our corporate clients, 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 corporate side, this means boards need to be thoughtful about ensuring that shareholders understand board commitment to 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 the same fair, thoughtful consideration of incumbent board and management views that we encourage clients to give activist shareholder views. We urge our clients to promote change in the following areas:

- 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 value at that particular company.
- Encourage an active 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 when there can be real harm in removing existing directors and adding new directors who may create discord and not make a positive contribution to 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 services also can encourage ISS to improve the quality of its recommendations and its focus on value creation. In our experience, 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.

CONCLUDING THOUGHTS

The pendulum of shareholder empowerment has swung sharply away from earlier days of substantial deference to the board. That pendulum 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. We believe clients will be better served by recognizing the new shareholder dynamic, staying in close touch with their major shareholders and utilizing a more sophisticated understanding of that dynamic to achieve better outcomes in activist campaigns. We also believe clients should 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.
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