
Papers

Dealing with investor activism: Investors seek cash returns from pushing your buttons — There are things you can do to prepare for an attack

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EXECUTIVE SUMMARY

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Investor activism has become an established strategy used by institutional investors, especially hedge funds, to enhance returns on their investments. These investors target corporations whose share price underperforms its peers and which either can be readily acquired or can generate and distribute substantial amounts of cash to shareholders. They use publicity and proxy contests, or the threats thereof, to

persuade managements to accede to their proposals. Unlike single-issue activists, who genuinely seek to reform corporate governance, investor activists are more likely to use criticisms of governance to put pressure on management. Recent research suggests that activist proposals, when implemented, generally do not create value for shareholders. Activists generally follow a pattern: First, they make a threshold-level investment. Secondly, they present a performance critique and a value-creation proposal to management. Thirdly, if rejected, they begin public criticism of the company's performance and governance. Fourthly, they seek support from other investors. Fifthly, if these steps do not lead to a satisfactory result, they launch a proxy contest seeking representation on the board of directors. Activists are often successful at winning support from other investors, including some for whom following other activists is a core strategy. When they launch proxy contests, their chances of success are relatively good. A company's best defence against activist predation is to win and maintain the endorsement of its largest shareholders before there is any sign of activist interest in its shares. This requires communication of a credible business strategy that explicitly includes a strategy for shareholder value creation. Once an activist investor takes a position in a company's shares, the best response is an ongoing dialogue with the investor. Both company and investor have incentives to avoid the costs and risks of a proxy contest, so it is often possible to reach an accommodation. Because this cannot be guaranteed, companies need to give serious



consideration to the circumstances in which they would accept one or more activists as members of their boards of directors. International Journal of Disclosure and Governance (2008) 5, 23–35. doi:10.1057/palgrave.jdg.2050070; published online 13 December 2007

INTRODUCTION

The activist investor is this decade's boardroom bogeyman. Somewhere, virtually every week, one or another of this new breed of invulnerable investor seizes board seats, humiliates managements, disrupts business strategies, forces huge unplanned payments to shareholders and even opens the gates to uninvited takeovers.

Worse, from his target's perspective, he generally uses little more than threats, press releases and the odd lawsuit. He puts very little of his clients' capital at risk. He thrives on adverse publicity. And he seems to get tolerance and even encouragement from courts and regulators. Small wonder that managements targeted by activists respond with outrage, managements not yet targeted, with bewilderment, and their legal advisors, with a smorgasbord of advice.

We sympathise. The activist phenomenon is so new that we are all a long way from consensus, practical, philosophical or legal. But it is, we think, possible today to reach a conceptual understanding of shareholder activism and to put forth some guidelines on how to deal with an activist should one take an interest in you. The notes that follow derive from our firm's participation in two dozen or so instances of shareholder activist in recent seasons, and from observation of as many more.

To start — we hate to start anything with a definition, but this one is important — an activist is nothing more than a shareholder who wants a return on his investment, especially a cash return, that is larger or faster than he would get if he sits idly by, and who takes action designed to get that return from management. Some activists paraphrase James Carville: 'It's the cash, stupid.'

Even more than the emphasis on cash, it is the willingness to take action that defines the group.

A 'passive' shareholder buys and holds shares, and then sells them when his investment goal is met or when a more attractive use for the funds comes along; his interaction with corporate management is limited to information-gathering. An 'active' shareholder, having bought shares, expresses views and recommends courses of action to management, sometimes supported by independent research, sometimes in concert with other shareholders, but he expresses his satisfaction or dissatisfaction with management's actions largely by a decision to buy or sell shares — not by noisemaking.

An 'activist' shareholder also recommends courses of action to management. But if they are rejected, he then takes action to persuade or compel management to his recommended course — most often, by recruiting other shareholders to his cause, by threatening or commencing litigation, by threatening or commencing a proxy fight or other governance action and by publicising any and all these actions. Activists are not, however, to be confused with (friendly) private-equity firms or (unfriendly) corporate raiders; activists generally have neither the inclination nor the capital or the expertise to buy or run the companies at which they direct their activism.

That said, here are themes that recur throughout our analysis: activist investors, good and bad alike, follow predictable patterns. Corporations, good and bad alike, can predict their vulnerability to activism; they can prepare for and sometimes deter possible attack; when attacked, they can defend themselves, and sometimes prevail.

IT'S A SIZABLE EPIDEMIC AND IT'S LIKELY TO PERSIST

Shareholder activism has neither league tables nor official scorekeepers. A proxy solicitation firm recently identified 75 incidents of publicly disclosed investor activism in 2006. That's one per cent of publicly traded US corporations. A similar number was projected for 2007 as that year draws to a close (there were 20 incidents in 2005). But in another 2007 survey of US



corporations, 40 per cent of respondents said a known activist had invested in their shares in the last year, and a firm that advises activist targets found 333 companies approached by 209 activist investors, leading to 627 activist-related events.

The gap between these numbers is largely definitional: at one extreme, an investor known for prior activism buys shares in a company but takes no action; at the other, the investor launches a proxy fight for board representation at the same company, with any number of possible actions or events between the two. But there's no good record of activists who bought shares, made an approach, were dissuaded and disappeared without notice.

Some of those activists were constructive influences; some weren't. Some of their targets probably benefited from their activism; some were harmed, even devastated. There's some disagreement about how much shareholder activism can be expected to grow in future years — but no one expects it to fade away.

Instances of shareholder activism go a long way back. It's been almost two decades, for example, since a bunch of disgruntled institutional investors got together, voted out the board of Xtra Corp. and wound up running the trucking company themselves. Relational Investors, probably the best known of the strategic activist investment concerns, dates back to 1996. Many of the activists' governance-related themes appeared even earlier, in the 1960s and 1970s, voiced by gadfly shareholders like Wilma Soss and the Gilbert brothers and by social and political activists pursuing non-financial goals. The rising incidence of activism in the last several years has, in our view, two primary causes:

The first cause was the dramatic proliferation of hedge funds, which, in the United States, are now estimated to number more than 8,000, managing more than \$2 trillion. By way of context, there are fewer than 6,000 publicly traded corporations domiciled in the US. This astonishing growth was spurred in part by the copious liquidity flowing into the financial markets since the 9/11 terrorist events and the

dot-com market crash, in part by the minimal regulation of hedge funds when compared to other investment vehicles, and in part by the eye-popping returns earned by some of the early entrants into the hedge-fund space.

Early hedge funds had an edge: They could use investment strategies and vehicles that more conventional (and more heavily regulated) investment institutions could not. As hedge funds multiplied, the most lucrative investment opportunities became fully populated, and then overcrowded. The search for above-average returns that did not involve above-average risk became a matter of considerable urgency for hedge-fund managers.¹ In addition, hedge funds began to compete with conventional, ERISA-constrained money managers for institutional investor clients, creating a need not only to show above-average returns, but to do so quickly, preferably quarterly. Thus they became activist investors.

The second cause was the new generation of regulatory oversight triggered by the Enron, Worldcom and assorted lesser scandals that began the new millennium, most critically the Sarbanes-Oxley Act of 2002. The message to corporate boards of directors was unequivocal: Directors were elected to look out for the financial interests of shareholders; they were expected to be active, not passive, in looking out for those interests; and if they didn't make enough of a good-faith effort to do this looking out, they could face personal legal liability.

Wakened in this fashion, boards reacted unevenly to their freshly restated responsibilities. Attorneys and consultants told them what they must do, what they could do and what they could not do — but only rarely what they *should* do. Overreaction to threat has become commonplace. In at least a few cases, directors have approved the sale of their companies not because they particularly liked the deal they were offered, but because they were fearful of the litigation consequences of saying no. Martin Lipton, the elder statesman of corporate legal advisers, calls shareholder activism the number one issue facing boards today.² In this climate,



activist shareholders arguing for various strategic actions as necessary creations of shareholder value receive board-level attentiveness that would have been quite unlikely a decade earlier.

And then, of course, there were early successes to lure new activists: companies were sold, special dividends paid, CEOs fired. The economics can be seductive. An activist puts relatively little capital at risk: he buys a stake in a company, but can usually sell it without substantial loss if his activism bears no fruit. Meetings and press releases cost next to nothing. The early stages of litigation aren't particularly costly. Only full-blown proxy fights are expensive; they are, not surprisingly, comparatively rare in shareholder-activism situations. An activist who succeeds only half the time, or perhaps even less often, will generate a very useful increment to his investment returns.

Shareholder activism, then, is very much a product of the market conditions that have prevailed since the millennium. Obviously, those conditions have changed dramatically since mid-summer of 2007, and continue to evolve as this paper goes to press. What is clear is that it will be more difficult or costly, at least in the near term, for activists to raise debt capital with which to purchase their stakes in target corporations, and also more difficult or costly for their targets to raise debt capital with which to execute the stratagems their activist investors propose.

Does this mean an end to investor activism? We don't think so. The more offensive and coercive manifestations of activism may become rarer and more muted. But the two pillars of 21st-century activism are durable — a stronger voice for shareholders in the strategic management of the corporation, and a consequently greater emphasis on timely and tangible returns from corporations to their investors. Whether these are good or bad developments is probably irrelevant: they are the new reality.

CASH EXTRACTION, YES PERFORMANCE ENHANCEMENT, NO

By choice, the outside incremental return the activist seeks is, as noted earlier, cash-denomi-

nated. How are you, the target corporation, going to give them that cash return? Three preferred avenues: You can buy back a lot of shares. You can pay a whopping special dividend. Or, best of all, you can sell the company for a tidy premium. One well-known activist, Chapman Capital, says it devotes more than half its portfolio to 'software and technology companies that are better suited to be part of a larger organisation' due to inadequate scale combined with spotty execution.

If you don't sell the company, and you don't have a mountain of cash on the balance sheet where does the money come from? Activists will recommend that you sell assets, especially big ones, even whole businesses. They'll recommend that you reduce expenses. Defer capital programmes. Raid working capital. Leverage yourself (borrow the money that you're going to pay out).

This catalogue of activities suggests two quick tests of your corporation's potential attractiveness as an activist target. Test number one: Is your share price a laggard? Compared to what? Compared to your peer group, or whatever else your major investors normally compare you to. If you're a star performer, you are already generating superior returns for your investors. There's not much upside for an activist campaign, and not much chance of broad shareholder support for such a campaign. Test number two: Can you in fact generate a timely pile of cash to give to shareholders, by spending less, by deferring capital programmes, by tapping bank balances, by borrowing or by selling assets? If not, you're probably immune to activism — unless, of course, there's an obvious buyer out there who'd pay up for your shares. (Sheer size, we note in passing, decreases but does not eliminate vulnerability to activism.)

Are these good ideas, these stratagems for raising cash and distributing it to shareholders? Maybe. Maybe not. But by the time it's clear they were bad ideas, your activist will be long gone. Two Harvard Business School scholars recently found that activists reliably boost shareholder value only when they persuade boards of directors to sell their companies.³



Their other initiatives, in general, don't do much for shareholder value. In a similar vein, scholars at the New York University School of Business found that earnings per share, returns on assets and returns on equity decline in the year following an activist's initial public assault.⁴ The activists succeeded in extracting cash, but not in enhancing performance.

ACTIVISTS TO BOARDS OF DIRECTORS RETHINK YOUR STRATEGY, GOVERNANCE

Activist investors' proposals almost always have at least one of these three characteristics. First, they privilege short-term returns and payouts over longer-term investments that might lead to greater returns; they disadvantage capital spending, research & development, acquisitions and entrepreneurship. Secondly, they privilege one group of shareholders (the ones who demand short-term returns and payouts) over another (the ones who wanted, or at least accepted, a longer-term orientation). Thirdly, they privilege shareholders over other constituencies, including employees, customers, vendors, partners and communities — the classic shareholder vs stakeholder debate, updated.

It is a rare board of directors that possesses either the conceptual framework or the established process to resolve questions of this sort within a short period of time. Nor does it help that many activists are, by temperament or tactic, confrontational, threatening and insulting, while boards of directors are mostly populated by people who have grown quite unused to such conduct.

The activist's challenge has become even more difficult for directors in this post Sarbanes-Oxley world. Until the recent Sarbanes-Oxley-stimulated revitalisation of corporate boards of directors, the relative passivity of most boards, and the domination of those boards by management, were accepted commonplaces. The SoX era awakened boards to their responsibilities, but it also told the world at large that managements COULD be questioned and called to account, and investors began to do so a lot more frequently because

boards were sensitised, perhaps overly sensitised to their responsibilities. In many ways, this has been a positive development. But one by-product of this process is that activists learned that boards, unsure of their ground, were pretty easy to bully, and from this came a lot of the fuel for activism and much of the increased ambiguity about how boards should respond.

How the board responds — of course — has consequences that are anything but academic. A client of ours a few years back bowed to the demands of one of today's best-known activists, who had threatened a proxy fight and appeared to have a fair chance of winning. The company borrowed a great deal of money and paid it out to shareholders in the manner prescribed by the activist, who sold his shares shortly thereafter. Two years later, a major competitor unveiled a new generation of core technology; the company knew how to respond, but, already deeply leveraged, could not borrow or otherwise raise the needed capital to do so. The competitor's market share soared. Desperate, the company hired a leading investment bank to 'explore strategic alternatives'. The banker returned six months later to report that no one, anywhere in the world, would buy or invest in the company — at any price. The company, permanently damaged, survives today as a fringe player in a field it once dominated.

Boards should also be keenly aware that the activists' approach will not always be frontal — nor will his argument be exclusively financial. This is where the term 'governance' becomes relevant, not because 'improved' corporate governance is a fundamental mission of the activist, but rather because it's a handy weapon used by activists to achieve financial goals.

Corporate managements and their boards of directors aren't generally enthusiastic about activists' proposals. If handing out lots of cash were part of their strategy, they'd already be doing it. So how, short of winning a shareholder vote of some kind, can the activist bring balky directors around? Here's how: Embarrass them. Activists accuse management of inattention to the business, making bad strategic decisions,



rubberstamping anything management proposes, ignoring the best interests of shareholders. These are all OK as accusations (remember, if management didn't have a laggard share price and the potential for raising some distributable cash, the activists would not be at the door).

Activists accuse management of lax or improper governance practices. Favourite topics: Conflicts of interest involving board members; overpayment of management; overpayment of board members; entrenchment of directors or management. In today's climate of post-Enron vigilantism, the media report most such accusations uncritically and at length. Most managements respond badly to this sort of attack — either legal boilerplate or indignant incoherence — but, in fairness, it's practically impossible to say 'I am not a crook' in a way that doesn't sound defensive and just a little bit guilty.

Governance attacks can become intentionally quite personal. One activist took full-page newspaper ads in a target board's hometown newspapers, with prison-style mug shots of the directors and a catalogue of their alleged sins under the headline 'Long-Term Liabilities'. This kind of *ad hominem* attack is, on occasion, quite effective in persuading board members to cave in to proposals they really don't believe in, just to stop the personal pain or embarrassment. Once the strategic or cash-generating event is launched, the governance accusations tend to fade away. In this respect, investor activists differ from so-called 'single-issue activists', which tend to be social-reform organisations (or sometimes public pension funds) that are genuinely focused on governance reform regardless of its consequences for financial performance.

Consider the activist syllogism thus communicated to fellow shareholders: 1. Our company is underperforming. 2. Our company isn't giving us the current (cash) value it could. 3. The reason is that our board is taking care of itself, not taking care of business. 4. Join us in telling our board to shape up. 5. If they don't shape up, put us on the board and we'll shape them up.

To make this request of other, more conventional investors, activists need to show a serious level of investment in their targets. The five per cent-of-outstanding-shares threshold for required filing with the US Securities & Exchange Commission is a common benchmark — by passing the required-filing level, an activist is announcing that he wants to be noticed. For companies with market capitalisations under \$1 billion, activists may accumulate 10 per cent or more of the shares. For very large market capitalisations, a stake as small as one or two per cent can still provide sufficient credibility if the activist appears able to rally other like-minded investors to his cause.

DIALOGUE IS GOOD: TAKE THE FIRST MEETING

Having accumulated a credible stake in a target corporation, the activist begins his campaign with a request for a meeting with management. There's no immutable pattern here. Some requests are long formal letters setting forth lists of concerns. Others are casual phone calls quite vague about their actual agenda. But almost always the activist will want to present an analysis of the company's underperformance and offer ideas for creating shareholder value through cash generation and distribution. Governance questions may or may not be on the agenda.

Should management take this meeting? The legal opinions we've heard are divided. From a non-legal perspective, we'd almost always argue that they should. Four reasons follow:

Reason No. 1: This is a courtesy management would probably accord any shareholder who owned a large block of shares. Indeed, while some activists become shareholders because they are activists — other activists are long-standing shareholders who take up activism, often reluctantly, out of unhappiness or frustration with their investment's recent performance or future prospects.

Reason No. 2: Activists are smart people, especially in the ways that corporate finance can be used to realise value for shareholders.



Your activist might have a useful idea, analysis or perspective to offer. And even if the ideas are unappealing or unworkable, they will likely have been pre-tested for their attractiveness to others among your shareholder base. Even dumb ideas have to be defeated, not merely dismissed.

Reason No. 3: Occasionally, management can persuade activists that their analysis is faulty or that their proposals are unworkable or harmful to shareholder value. Smart as they are, they do not know your business as well as management does. A deeper understanding of the industry conditions, competitive opportunities and challenges, and operating constraints may convince an activist that his proposals are inappropriate or, more likely, premature. Can this be done within the constraints of the SEC's Regulation FD? Yes. Well-marshaled non-material information can have a real impact.

Reason No. 4: If neither management nor activist can lead the other to a mutually acceptable understanding, there's likely to be a war. Personal contact is the best road to agreement. And if you are going to war, knowing your enemy is a good thing. (For the media shy here's a sometimes Reason No. 5: When you say no to the meeting, the activists will make your rejection into headline news.)

The activist makes a proposal. Management relays the proposal to the board. Now the board must determine how to respond to the proposal. In some cases, this is easy: Some proposals are impracticable, ridiculous or impossible — but this is rare. Others suggest avenues that the board has already explored and rejected, and the reasons for rejection can often be readily conveyed to the activist and, when necessary, the entire shareholder population. Many boards of directors make it an annual practice to ask their investment bankers to determine whether their corporation could be sold, and at what price, under then-prevailing market conditions. This determination then becomes a yardstick against which to appraise the values to be created by executing on the corporate strategy. Some boards are

now additionally asking their investment bankers to evaluate other financial alternatives that liberate cash for distribution for shareholders. Indeed, one client of ours carried the day against a phalanx of hedge-fund activists because it had for several years rigorously explored strategic options with outside advisors: it had done more and better homework than its attackers.

The more difficult — and dangerous — situation arises when an activist presents a proposal that is both credible and feasible but at variance with the corporation's established strategic direction. Many boards are singularly ill-prepared for this eventuality. The theory is simple enough: Shareholders elect boards to act on their behalf, and boards are supposed diligently to apply their best-informed judgment to that end. Boards, having embarked on a strategy, should not change it in mid-course. But boards, elected to serve shareholders, should also be sensitive to those shareholders' expressed desires. Few boards contemplate how to sort through such situations until they find themselves in one. The legal profession has provided a valuable body of advice on what a board must do, and on what a board can do, but that advice does not extend to what a board should do. In particular, each board needs to develop a common view of how to compare a strategy that involves near-term benefits and long-term costs with another that involves near-term costs and long-term benefits, and how also to evaluate strategies that benefit shareholders (or more narrowly, cash-oriented shareholders) at the expense of employees, customers, communities or other constituencies.

THE REAL BATTLEGROUND: VALUE-CREATION STRATEGY

We now arrive at a central consideration: a corporation is essentially invulnerable to activist investors if the three conditions that follow are met. Alternatively stated, an activist investor will almost never target a company if these three conditions are met.



Condition No. 1: Management has formulated and the board of directors endorsed a strategy for shareholder value creation. This is effectively the punch line of a larger corporate strategy, as in, ‘if we succeed in doing all the things listed, here’s how it translates into money in our shareholders’ pockets’. Money in pocket, however, does not necessarily mean cash payment; share price appreciation still commands investor respect.

Condition No. 2: The company’s strategy for shareholder value creation has been communicated to shareholders; and

Condition No. 3: The company’s strategy for shareholder value creation has been understood and approved by shareholders. Approval in this context doesn’t mean a vote at a meeting. Investors can express approval via checkbook. An investor who buys shares after being clearly told what a corporation intends to do can usually be assumed to approve the stated course of action.

Here’s the recurrent problem: Over and over again, in our practice, we encounter boards of directors who know to a certainty that they have formulated, and management has communicated, just such strategies for shareholder value creation — but when we talk to their shareholders, those investors say they either have no idea what the strategy is, or else that they think the strategy that they’ve heard is a truly terrible one. The gap between these two perceptions is the opening through which an activist investor enters the corporate landscape.

What to do about such a deadly disconnect? If there’s no activist at the door, then, it’s extremely useful — and prophylactic — to sample the views of investors, to see whether they accurately perceive this strategy for shareholder creation, and to see how they feel about it. Not only does the exercise provide vital information, investors like the idea that their company is soliciting their views. There is still utility to such a sampling of opinion after an activist has purchased a stake but before he has launched a public campaign, primarily as a guide to decision-making, since there will be

little time available if more substantial remediation is called for. And of course, a company’s motives in seeking investor views will be sharply questioned once an activist does launch a public campaign.

What’s been described thus far is pretty unexceptional behaviour on the part of the investor: you’d expect an institution that’s made a major investment to speak its mind if the results it sees aren’t appealing, and you’d hope that management would take seriously what the institution had to say. Where the conduct most commonly considered activism begins is when the investor’s value-creation proposals are rejected. Where the traditional, non-confrontational investor opts either to sell or to grin and bear it, the activist takes actions intended to persuade or compel the board of directors to adopt his proposal or to provide some other value-creating concession.

THE ACTIVIST POST-REJECTION: NO MORE SWEETNESS AND LIGHT?

Activists’ actions after rejection of their proposals follow very similar patterns:

First, they try to go over management’s head. They demand a meeting with the full board of directors. Or with the independent members of the board. Usually, this demand should be rejected. If a board is not prepared to reconsider its decision, there’s nothing to talk about. If a board is prepared to reconsider, then the board should determine for itself what new information or opinion it requires, not simply respond to the initiatives of a single shareholder. Activists know this. When they get a meeting with the board, their goal is often either to create divisiveness within the board or to collect material for subsequent publicity, litigation or proxy contest. Indeed, the request itself is commonly made in the hope of eliciting an ill-considered and media-worthy response. Important: Continued meetings at the management level can be hugely important even if board-level dialogue is rejected. And sometimes allowing a lead independent director



or non-executive chairman to sit in is a useful compromise.

Second, activists attack the governance practices of the board. The most common topics are the independence (or lack thereof) of the board's independent directors; the appropriateness of business dealings (and disclosure thereof) between directors and the company; compensation of directors and of management; the diligence with which the board has created or reviewed corporate strategy, financial and accounting practices; and generally, the quality of the efforts the directors have made to look out for the interests of their fellow shareholders.

The sincerity with which activists put forth these accusations varies widely. Single-issue activists pursue reforms in corporate governance simply because they believe them to be right; there's no apparent expectation of profit in their quest for reform. Financial activists (the subject of this commentary) are far more likely to treat governance issues as prods to apply to reluctant boards. When financial activists reach settlements with their targets, their governance demands are usually withdrawn or watered down to the merest of symbols if the financial concessions are sufficiently concrete.

Third, the activist tries to drum up support among his fellow large investors. Finding out who they are can be the hardest part of this task. Conventional large institutional investors file their holdings with the Securities & Exchange Commission, but these filings can be quite out of date by the time they're available, while hedge funds, the investors most likely to support an activist, move so rapidly and are so lightly regulated that determining their real-time holdings can be quite difficult. The simplest approach for an activist is to purchase five per cent or more of the company's shares, the level at which timely filing with the SEC is required. That filing (Form 13-D) announces the activist's presence and alerts similarly minded investors without committing anyone to any particular course of action.

THE ACTIVIST GOES PUBLIC

The overt vehicle for building support and levying accusations is generally a public statement, usually a letter to the board of directors that may also be issued to the news media (and filed with the Securities & Exchange Commission). This letter criticises the board for refusing to meet with the activist; criticises the board for failing to accede to the activist's proposals; details the company's business underperformance and its laggard shareholder value creation; assails the board's lax governance practices; renews the activist's demands for value creation and board-level interaction; and either hints at or explicitly threatens a proxy contest or some form of shareholder litigation. Board seats are sometimes demanded, sometimes left unmentioned so they can be placed on the table at a later, more strategic moment.

There is no prevalent timing to this sort of campaign — except the timing that relates to proxy contests, specifically the deadline for the filing of a slate of candidates for election to the board of directors or proposals to be considered by the shareholders. If the threat or reality of a proxy contest is central to an activist's strategy, that will dictate the timing of whatever actions or communications precede the launching of the contest.

The US news media give activist accusations substantial and generally favourable coverage. Partly this is because activists provide colourful quotations and vivid accusations that make good copy for the media's readers and viewers. Partly, this is because the media's prevailing 'X accused, Y denied, Z commented' format favours the party making the accusations. And partly this is because most corporations do a terrible job of defending themselves when attacked through the news media. The most common corporate mistake: firing off *ad hominem* attacks and ignoring the question of value creation.

The heart of an activist campaign takes place between the moment that an activist announces intent to persuade its target to change its conduct and the moment that the activist



decides to wage a proxy contest (activists win most of the proxy contests they launch, but that's logical enough. Proxy contests can be expensive, and an activist isn't likely to get into a costly public fight he isn't highly likely to win).

KNOW YOUR ACTIVIST

There is a hierarchy of investor activism. At the peak of the pyramid are the 'strategic activists', a couple of dozen institutions, nearly all of them hedge funds, whose core strategy is to invest in companies where the tools of corporate governance can be used to enhance shareholder returns (Relational Investors, founded in part with California state pension funds, is the doyen of this group). Next come 'situational activists', institutions and funds that use activism occasionally, as part of a broader range of investment strategies. Similar in their level of intensity are the 'reluctant activists', typically conventional investment institutions that resort to activism only out of frustration at long-running underperformance and unresponsiveness on the part of a corporation in their portfolio.

Each of these categories of activist is prepared to act on its own or as the leader of a larger campaign. Beneath them, in the middle of the pyramid of activism, are the 'wolfpack investors'. These investors, usually hedge funds, invest in companies in which another activist has already taken a position, and then communicate to management (and, often, the public) their support for the activist's agenda. Within six hours of Formation Capital's announcement in 2005 that it owned 8.8 per cent of Beverly Enterprises, it became known that another 33 per cent of Beverly's shares had been accumulated by other hedge funds and arbitrageurs. There are a hundred or so hedge funds that make a regular practice of wolfpack investing; many describe themselves as 'event-driven'.

And then there are the 'activist sympathisers', institutional investors of every stripe who want the near-term values a successful activist might stimulate, but not the opprobrium of being

labelled activists themselves. These investors' recurrent message to corporate management: 'We just want you to make this go away.' This is functionally equivalent to saying 'do what the activist wants', since that's the only way the corporation can 'make this go away'. Another formulation of the same sentiment is 'What harm could it do?' — used particularly in the context of an activist's desire for board representation, and carrying the same do-what-they-want message.

PROXY FIGHTS CAN BE LOSE/LOSE; KEEP THE DIALOGUE GOING

A proxy contest is the threatened end point to the public phase of an activist campaign, but neither side really wants a proxy contest to take place. The company for obvious reasons — the likelihood is that if an activist is confident enough to launch one, he'll probably prevail, and place himself and a colleague or two in the boardroom. Even companies that win proxy contests face lost momentum, lost morale and heightened vulnerability to competitors and predators. But the activist doesn't want the fight either, not only because it's expensive and time-consuming, but, more to the point, his real goal is a cash-liberating, value-creating event right now, and winning a proxy fight only gives him a better position from which to argue for such an event sometime in the future.

Hence, the activist's position with management is 'do what I want and I'll go away'. His position with other shareholders is 'tell management you're with me and we'll all get what we want'. And his public position is 'mismanagement, underperformance and bad governance', teeing up the themes on which a proxy fight would be waged.

Management's position with the activist, conversely, is 'what you want is impossible or harmful. Let's talk about what's real and practical'. Management's position with shareholders is 'you'll get greater value from your investment if we follow our strategy rather than acceding to the activist's proposals'. And



management's public position is exactly the same, 'greater shareholder value creation'.

Here is where too many managements shoot themselves in the foot. Their instinct is to fight back, point for point, in the news media or in shareholder communications. They defend their performance (if it weren't inferior, they wouldn't have been targeted). They defend their strategic plans (if investors widely knew and approved them, again they would not have been targeted). They defend their governance (which few investors actually care about). They attack their attackers (ditto). They forget: The debate is about shareholder value creation, and the side that abandons the topic will be the loser. Companies must be as single-minded in dealing with news media as political candidates in the run-up to an election.

This is a popularity contest. A very-high-stakes popularity contest. We have seen an activist investor fold his tents and decamp after two phone calls from very large investors saying 'we like what the company is doing; we won't back you'. At the other extreme, we have seen wolfpack investors and activist sympathisers move into a stock so quickly and quietly that the activist could seemingly overnight claim overwhelming backing — and thereby shock the board into accepting his agenda. The appearance of support for an activist in the range of 20 to 30 per cent of outstanding shares is not uncommon, but majorities are rare. The degree of apparent support or non-support for an activist is crucial to management decision-making. Note the word 'apparent': a phone call to management isn't at all the same as a vote cast in a proxy contest. As noted earlier, there is no substitute for talking frankly with your largest shareholders, to determine their level of understanding and approval of your corporate direction — in the end, fewer than 50 investors, and even as few as five, will decide an activist campaign.

Management going-in discussions with an activist during the post-going-public, pre-proxy-fight stage have three extreme outcomes and two intermediate outcomes. The extremes are: (a) the corporation accepts the activist programme in its entirety; (b) the corporation

persuades the activist not to pursue his programme any further; and (c) the activist launches a proxy contest. One intermediate outcome is a negotiated commitment to pursue some mutually acceptable portion of the activist agenda (such as, prosaically, a smaller share repurchase than originally proposed, perhaps coupled with a symbolic change in a governance practice or two). The other intermediate outcome is the acceptance of activist representation on the board of directors.

AN ACTIVIST ON YOUR BOARD? GIVE IT SOME THOUGHT

Should a corporation give an activist representation on the board? It won't want to. But it may have to. If the matter does go to a proxy context, there's a good chance shareholders will give activists the seats they seek. Yes, seats — activists who once sought a single seat now routinely ask for two or three. Not only do many conventional investors have a 'what harm could it do?' philosophy, but a quarter to a third of most corporation's shares are influenced in proxy contests by Institutional Shareholder Services, a powerful advisory service that, in 2007, set a rather low hurdle for approval of minority representation for activists on corporate boards: while an activist seeking board control must present to ISS a detailed strategic analysis, business plan and management slate, an activist seeking anything less than control need only show that change would be desirable at the corporation and that the activist's candidates would bring new and valuable perspectives to the board's deliberations. So at the very least, your board of directors should give advance consideration to the subject. Some elements of this consideration:

Is a board seat a victory, or a defeat? It's not always clear. For the activist, board representation is a concession by the company (a win), but it's not a value-creating event (a loss), but then again, it's a better platform from which to argue for that event (a win). For the company, the flip side applies: It's a concession to the activist (a loss),



but it's not a rejection of strategy or weakening of financial resources (a win), but then again, it lets the activist into the boardroom (a loss).

The activist himself has a conflict-of-interest hurdle to clear. He has a fiduciary duty to his own investors. But in accepting a board seat, he assumes a fiduciary duty to the corporation's shareholders. The interests of these two constituencies may often overlap, but it's far from clear that they can be considered identical. When pressed on the subject, some activists will respond, first, that their interests are the same as the interests of all the corporation's other shareholders, and second, that the interests of the corporation are indistinguishable from those of its shareholders. We assume that sooner or later, a court will be asked to validate these principles.

At the purely practical level, the track record of activist investors as board members is greatly varied. In our experience, some activists (or activist designees) make hugely valuable contributions to corporate strategy and management. Some advocate their value-creation principles to no particular effect. Some have, against all expectations, become cheerleaders for the managements and strategies they assailed as outsiders. And some have persuaded their fellow directors to replace the chief executive officer or to sell the company (a cruel irony we have seen more than once: activist directors may so paralyse or polarise a board that it sells the company just to 'stop the pain,' at a lower price than could have been obtained through a less stress-induced process, thereby creating a value-destroying event rather than a value-creating one).

How to find out what sort of new directors you might be welcoming? They should be treated the same way any other serious candidate for board membership would be treated. The major strategic activists are no longer strangers to the corporate boardroom. Review their track record as board members elsewhere. Check their references. Interview them, in person and at length.

There is one last stratagem that has been successfully applied when it becomes clear that no compromise with an activist is possible and that the activist would likely prevail in a

proxy contest — pre-emptive value creation. This involves a corporation taking as many activist-proposed steps as it can without, in the board's view, causing lasting damage to the business. For example, a moderate share repurchase, modification of a criticised governance item and nomination of a known shareholder-friendly new board member. The message to shareholders other than the activist is, in effect, 'this is the best we can do for you right now. If you want more, on your head be it'. We have seen this approach, implemented at an early point in an activist campaign, cause the activist to lose support and stand down, albeit with a face-saving claim of credit for the actions taken. This is tricky stuff, though; for one thing, it may not work. For another, it raises ethical and possibly legal questions: Is it in the shareholders' best interest to repel this particular activist? And if it is, what burden does that justify placing on the business of the corporation?

Proxy contests have been extensively discussed elsewhere, and need not be revisited extensively here. The key points are these: a proxy contest means that all other alternatives have failed. Activists don't launch proxy contests they aren't very confident of winning. The contest will be decided by a small number of large shareholders (and by ISS and the smaller proxy advisory services). The battleground will be shareholder value creation. Lip service must be paid to governance issues if they are offered. But the argument that must be defeated by the corporation is 'what harm will it do?' Past history and current legality are harmful distractions. Anger loses. So does verbosity. Large shareholders will give the corporation 'one last chance' to present, usually in person, an argument to the effect that 'our plan produces more value than theirs, and giving them board seats harms our plan'. Don't waste that one last chance.

'One last chance' is an apt consideration for the entire question of shareholder activism. Corporations that are performing very well are virtually immune to activism. Corporations whose shareholders believe they will perform well in the future are, if not immune, at least

adequately protected. Activists are investors who want a particular kind of better performance, and are willing to take confrontational action to get that better performance. The best tactic for dealing with an activist is open dialogue. The best strategy for defeating an activist is to deliver better performance (the activist's kind) in the near term, or to prove (not merely promise) much better performance (the corporation's kind) in the future, or to demonstrate that neither is possible. Everything else is a distraction. In the end, investor activism, for both investor and corporation, is about performance and communication — and, of course, cash.

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