

Dealing with activist investors

On March 19, 2014, members of the Audit Committee Leadership Network (ACLN) met in New York to discuss investor activism, in particular the activism focused on company performance and shareholder value (as opposed to political or social causes).¹ In this session, members were joined by Andy Merrill, senior managing director at Teneo Strategy². Members also discussed the topic with G. Mason Morfit, an activist investor with ValueAct Capital who recently joined the board of Microsoft, in a complementary session over dinner on March 18. For biographies of Mr. Merrill and Mr. Morfit, see Appendix 1, on page 12. For a list of participants, see Appendix 2, on page 13.

Executive summary

In their conversations with Mr. Merrill and Mr. Morfit, ACLN members touched on four topics:

- **Today's activist investors** (*page 2*)

Activists today are more numerous and well funded than in the past, and their activities are drawing more media interest. They are targeting larger companies, and they are receiving more support from institutional investors, allowing them to exert influence even when their positions in a company are relatively small. While the old brand of confrontational activism has not disappeared, a new brand of collaborative activism focused on long-term performance has emerged. Recent empirical studies suggest that activists can have a positive influence on long-term operating performance and stock returns.

- **Preparing for an activist challenge** (*page 5*)

Mr. Merrill and ACLN members emphasized that companies should prepare for an activist's approach in advance. Companies should assess and address the vulnerabilities that might spark an activist's interest, such as poor operational performance or shareholder returns, and they should have a plan ready for implementation if an activist approaches. An ongoing effort to build strong relationships with the company's major investors is critical. Understanding legal defenses such as shareholder rights plans (poison pills) is also advisable.

- **Responding to an activist challenge** (*page 7*)

If an activist approaches the company, Mr. Merrill and the members agreed, the first step should be to engage with the activist, listening to his or her arguments with an open mind. The activist's ideas may be constructive, and a dialogue could lead to a mutually acceptable plan for addressing the activist's concerns and recommendations. Only after exhausting efforts to reach an amicable agreement should a company fight back against an activist, and legal defenses such as poison pills used as a last resort.

¹ *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

² In the other session, members engaged in a dialogue with Joseph Demarest, assistant director at the Federal Bureau of Investigation and head of the Cyber Division. See Audit Committee Leadership Network, "[An update on cybersecurity.](#)" *ViewPoints*, April 24, 2014.

- **Working with an activist board member** (page 9)

Mr. Morfit argued that an activist investor can bring valuable knowledge and perspectives to a board. Members agreed, but they said that it is important for an activist board member to build trust and mitigate concerns about representing all the investors. They also noted that the realities of serving on a board and managing exposure to insider information could prompt an activist investor to decide on the appointment of an independent, mutually agreed board member instead.

For a list of discussion questions for boards and audit committees, see Appendix 3, on page 14.

Today's investor activists

Investor activists are in the spotlight again, as a number of important trends have become evident in the last several years and debates about the impact of activism have heated up.

Recent trends in activism

Investor activism is not a new phenomenon, but activist investors' approaches have changed in recent years. Such developments as the move to declassify boards and adopt majority-voting standards,³ along with a rapidly evolving media environment, have served to amplify the leverage available to activists:

- **More activists and more firepower.** The number of investors with a stated activist strategy has more than doubled over the last decade,⁴ and institutional investors are putting more money into activist funds.⁵ By some estimates, assets under management at activist hedge funds have increased from less than \$12 billion to more than \$100 billion in the last decade.⁶ Activist shareholder interventions (e.g., seeking board representation, share buybacks, CEO removal) increased 88% between January 1, 2010, and September 20, 2013, with the majority of that growth in Europe and the United States.⁷ More proxy fights were announced in 2013 than in any year since 2009.⁸ And increasing levels of cash on corporate balance sheets has motivated activists to get involved.⁹
- **Media interest.** Even activists with relatively small stakes – such as ValueAct's 0.8% position in Microsoft, Pershing Square's 1% position in Procter & Gamble, and Barington's position stake in Darden

³ See, for example, Ted Knutson, "[S&P 500 Moving Towards Declassification, Annual Board Elections.](#)" *Corporate Secretary*, March 1, 2013; Lucian Bebchuk, Scott Hirst, and June Rhee, "[Towards Board Declassification at 100 S&P 500 and Fortune 500 Companies: Advancing Annual Elections in the 2014 Proxy Season.](#)" *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), December 10, 2013; Tapestry Networks, Cadwalader, Wickersham & Taft LLP, and Teneo Holdings, [Introduction to the SDX Protocol](#) (2014), 2 (noting success of Harvard Law School's Shareholder Rights Project).

⁴ Cal Smith, "[Responding to the New Shareholder Activism.](#)" *King and Spalding Directors Governance Center*, December 4, 2013; see also Linklaters, "[Activist Investors Turn Up the Heat in Global Boardrooms.](#)" news release, November 11, 2013.

⁵ Stephen F. Arcano and Richard J. Grossman, "[Activist Shareholders in the US: A Changing Landscape.](#)" *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), June 28, 2013.

⁶ Smith, "[Responding to the New Shareholder Activism.](#)"

⁷ Linklaters, "[Activist Investors Turn Up the Heat in Global Boardrooms.](#)"

⁸ Kerry E. Berchem, "[Top 10 Topics for Directors.](#)" *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), December 31, 2013.

⁹ Jeff Green and Beth Jinks, "[Icahn's EBay Talks Show Boards Listening to Activists.](#)" *Bloomberg*, January 23, 2014.

Restaurants – can draw substantial media attention to their campaigns.¹⁰ Activists generate interest through social media postings as well.¹¹

- **Larger targets.** No longer focused on underperforming midcap companies, activist investors have stepped up their actions at companies with \$2 billion or greater market capitalization by 129% since January 2010.¹² The average market value of companies targeted by activists increased to \$8.2 billion in 2012, from \$3.9 billion in 2011.¹³ According to FactSet’s SharkWatch, as of October 2013, 50 value maximization and board seat campaigns had been announced against companies with \$1 billion or greater market capitalization, the most campaigns recorded since such tracking began in 2005.¹⁴ The shift away from classified boards has increased the vulnerability of even the largest companies.¹⁵
- **Increased support from institutional investors.** Institutional investors are increasingly aligning with activist investors to prod companies to change policies and practices. For example, the California State Teachers’ Retirement System recently co-sponsored a proposal with activist fund Relational Investors to break up Timken Co., a maker of steel and bearings in Ohio, because the Timken family held three of 11 board seats but only 10% of the company’s stock.¹⁶ In the words of one commentator, “Supporting activists has largely lost the stigma that it had among traditional institutional investors, which once may have viewed activists as a disruptive influence acting contrary to the long-term interests of the company, but today view activist investors as a useful tool.”¹⁷
- **A more collaborative tone.** Historically, activists were known for hyperbolic invective against companies and their managers. Although that still occurs, the *Financial Times* recently noted that activists have toned down their rhetoric and are “working harder to present credible plans and to propose serious board candidates.”¹⁸

The impact of activism

As investor activism has escalated, so has the debate over its impact. Do activist campaigns discipline underperforming companies, forcing them to provide better value for all their shareholders, or are such campaigns merely attempts to garner short-term gains, which are likely to come at the expense of long-term success? Can activists propose strategic moves that are constructive and worthy of management’s consideration, or do they just interfere with management’s ability to run the company effectively?

An empirical study released in 2013 looked at 2,000 interventions by activist hedge funds between 1994 and 2007, tracking companies’ operating performance and stock returns during the five years after the

¹⁰ Arcano and Grossman, “[Activist Shareholders in the US: A Changing Landscape.](#)”

¹¹ John C. Ogg, “[Are Activist Investors Starting to Overreach and Hurt Companies?](#)” *Yahoo Finance*, January 27, 2014.

¹² Linklaters, “[Activist Investors Turn Up the Heat in Global Boardrooms.](#)”

¹³ Smith, “[Responding to the New Shareholder Activism.](#)” see also James C. Woolery, “[Bridging the Chasm Between Boards and Shareholders.](#)” *Wall Street Journal*, October 9, 2013.

¹⁴ Berchem, “[Top 10 Topics for Directors.](#)”

¹⁵ Arcano and Grossman, “[Activist Shareholders in the US: A Changing Landscape.](#)”

¹⁶ Louis M. Thompson, “[When Pension Funds Turn Activists.](#)” *Compliance Week*, December 17, 2013.

¹⁷ Arcano and Grossman, “[Activist Shareholders in the US: A Changing Landscape.](#)”

¹⁸ Stephen Foley, “[Activist Hedge Fund Managers Get Board Welcome.](#)” *Financial Times*, December 23, 2013.

intervention; it also looked at the three years before the intervention and the three years after the activists exited the company.¹⁹ The study found that activist intervention improved operating performance during the five years after the intervention and that the activists' exit was not followed by abnormal long-term negative returns. A recent analysis of 400 activist campaigns by McKinsey & Company found that among large companies, "the median activist campaign reverses a downward trajectory in target-company performance and generates excess shareholder returns that persist for at least 36 months."²⁰

ACLN members were reluctant to generalize about the impact of shareholder activism. They were open to the possibility of positive impacts, but they were also aware of poor outcomes. One member noted, "[Activists are] a diverse group, and it depends on their motivations." Several members were concerned about a continuing bias toward short-term gains: "Activists used to look at the cash and talk about a lazy balance sheet; we're hearing this again. But you need ammunition for [mergers and acquisitions]. Activists don't want companies to hold onto ammunition – they say, 'If the idea is good enough, you'll get money.'"

Mr. Morfit noted that, like many investment strategies, investor activism has a cyclical aspect: while activist funds outperform the market, activist investors need to find ways of deploying their capital. "The strategy gets overdone. Newer funds are cropping up and raising money very quickly. Some ideas are pretty lame. It's over the top – dumb ideas that company CEOs have to waste time on," he said. Leo Strine, chief justice of the Delaware Supreme Court, recently argued that shareholder rights should be curtailed because the current "deluge" of corporate governance votes is a distraction for management and costly for companies.²¹

While he acknowledged the emergence of collaborative approaches, Mr. Merrill did not think the antagonistic types would disappear: "There will be a spectrum. Yes, some are taking a more constructive approach... but I don't think the 'flamethrowers' will go away. It's relatively easy and inexpensive to accumulate shares and publish or leak a letter to the board effectively putting a company in play."

ValueAct Capital: an example of constructive activism?

ValueAct's general strategy of investing is illustrative of a new type of activism that differs from the popular perception of what activists do. As Mr. Morfit explained, ValueAct was founded in 2000 with a specific idea in mind: "We would be value investors, taking an active role." The company's strategy includes several elements:

- **Focus and depth.** "Our focus is on a concentrated portfolio, where you really know your companies," Mr. Morfit said. The fund only holds 10 to 18 core investments at any given time. This approach allows the fund to conduct in-depth research and analysis on each company.

(continued on overleaf)

¹⁹ Lucian Bebchuk, Alon Brav, and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism* (New York: Columbia Business School, July 9, 2013), 37.

²⁰ Joseph Cyriac, Ruth De Backer, and Justin Sanders, "Preparing for Bigger, Bolder Shareholder Activists," *McKinsey Insights*, March 2014.

²¹ Stephen Foley, "Delaware Judge Calls for End to 'Deluge' of Activist Votes," *Financial Times*, March 24, 2014.

ValueAct Capital: an example of constructive activism? *(continued)*

- **A willingness to hold a stock for years.** Mr. Morfit noted, *“If we get high returns, we hold indefinitely. It’s better to ride winners.”* ValueAct’s average holding period is three to five years.
- **A collaborative approach.** ValueAct strives to work constructively with management and the board. Mr. Morfit explained, *“We didn’t want to wage campaigns on TV. We wanted to be a learning organization. We learned that boards don’t like being told what to do on TV. Business is done through personal relationships.”*

Preparing for an activist challenge

Experts on managing activist investors recommend that companies prepare in advance for potential challenges. In a pre-meeting conversation, Mr. Merrill said his firm is sometimes brought in even before an activist campaign has materialized, helping clients prepare an activist response playbook. He explained that speed is of the essence when an activist intervenes, so companies need to think about both their strategy and their tactics in advance. Experts and members have identified a number of ways to prepare.

Assess and address vulnerabilities

ACLN members expressed a strong interest in understanding exactly what attracts an activist investor to target a particular company. One member explained, *“Activists have played a role in our industry, so we have focused on it. What makes the company a target? Would we be a target? Is it revenue growth, margins, governance issues? We ask what prompts an activist to get involved, and we assess our company against these factors.”* External advisers can help companies perform a vulnerability assessment in the same way an activist might.

Red flags that might draw the attention of activists include poor operating performance or shareholder return, unplanned C-suite departures, significant litigation, and operational mishaps.²² Perceived weaknesses of the board itself, such as its composition, can also be a factor.²³ Some vulnerabilities can be mitigated to reduce the likelihood of activist intervention. For one ACLN member, the formula is simple: *“There’s no substitute for outperformance.”* Another member added, *“The best defense is a high share price. If the price lags but the business is good, it’s a profit opportunity.”* Mr. Merrill added that performing an inventory of governance practices was important: *“When a letter comes over the transom, there shouldn’t be anything in it that you have not already anticipated and considered and that you can’t defend against.”*

Prepare a team

Long before an activist declares an interest, companies can determine who from the management and the board will be part of the response team. Companies can also identify external advisers (investment banks, law firms, proxy solicitors, and other specialized consultancies) who may be called upon. The company can

²² Tapestry Networks, Cadwalader, Wickersham & Taft LLP, and Teneo Holdings, *Introduction to the SDX Protocol*.

²³ EY Center for Board Matters, *“Getting it right: succession planning for the boardroom and C-Suite.” Let’s talk: governance*, Issue 3, March 2014.

also explore in advance how the team might approach various decisions that would have to be made in the face of an activist campaign.²⁴

Know your investors

Companies should understand their major shareholders and establish good relationships with them. Mr Merrill explained, *“The time to get to know shareholders is not when an activist approaches. A big part is inoculation. Good shareholder relations are critical. It’s more than phone calls – it’s face-to-face meetings and listening to them.”* A recent study by Institutional Shareholder Services for the Investor Responsibility Research Center Institute found that engagement between companies and investors has continued to increase in the three years since a previous study found more engagement.²⁵

According to one analysis, *“Ongoing communications with significant shareholders in a manner compliant with Regulation FD [Fair Disclosure] help both to ensure that investors understand the company’s story and to provide an important avenue for feedback regarding shareholder views. The strength of the relationship with shareholders and whether shareholders trust management can make all the difference in the world if an activist situation emerges.”*²⁶ In addition, tracking the trading patterns of the company’s shares can provide clues to an emerging activist challenge, as can other advance warnings of shareholders’ intentions, such as certain SEC filings or statements made at investor conferences.²⁷

Consider legal defenses

Shareholder rights plans, or “poison pills,” are still effective defenses against activist interest. The current trend, however, is not to adopt one prematurely.²⁸ Bill Baxley, a partner with King & Spalding, told another director network, *“The trend is not to have a long-term [poison] pill in place because if you have one, you may get shareholder objections, including a potential shareholder proposal to remove it. Instead, companies often have them ‘on the shelf’ and adopt them in circumstances when they need it and with terms that are appropriate to the circumstances.”*²⁹ For more, see *“Resisting an activist,”* on page 8.

Keep the board updated

Management should keep the board informed of their discussions with activists. In a pre-meeting conversation, a member noted, *“It is important for management to make sure the board gets input in an unfiltered way. I get that kind of input: investor letters are shared with the board and there’s good discussion from management about what’s on the minds of the biggest shareholders. It serves to heighten our sensitivity about where the company is headed.”* Mr. Merrill made a similar point in the meeting: *“Management has an obligation to update boards. Most activists have a playbook. They do their*

²⁴ Arcano and Grossman, *“Activist Shareholders in the US: A Changing Landscape.”*

²⁵ Institutional Shareholder Services, *Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives* (New York: Investor Responsibility Research Center Institute, 2014).

²⁶ Arcano and Grossman, *“Activist Shareholders in the US: A Changing Landscape.”*

²⁷ *Ibid.*

²⁸ See, for example, John Laide, *“A New Era in Poison Pills – Specific Purpose Poison Pills.”* *SharkRepellent.net*, April 1, 2010.

²⁹ Lead Director Network, *“Dealing with shareholder activism.”* *ViewPoints*, April 1, 2014, page 6.

homework. The best defense is to regularly update the Board about corporate strategy, strategic alternatives and capital allocation policy, so they're not looking at it for the first time when an activist shows up and presents an alternative plan."

Enable the board to engage directly with shareholders

Another form of preparation is to strengthen the relationship between long-term investors and the board itself. This is the objective of the recently released Shareholder-Director Exchange (SDX) Protocol³⁰ which asserts that engagement can serve to balance an activist's influence.³¹

ACLN members were curious about direct engagement between boards and shareholders.

- Several members were skeptical of such engagement. One said, *"It's a bad idea. No board members have knowledge of the company that is one-tenth as insightful as that of the CEO or CFO. You could undermine management."* Indeed, a 2013 survey of listed companies by the National Investor Relations Institute found that 60% of companies explicitly forbid board members to speak directly to shareholders.³²
- Some saw room for more of it: *"You need to know what shareholders are thinking. It's a governance committee role, but some committees are not as aggressive as they should be."* Another member said, *"The SDX Protocol specifically speaks to those areas where the board can talk to investors without management – such as governance-related issues and broad strategy-related issues – not specific numbers, where management knows more."*

Responding to an activist challenge

Activist campaigns often present a major challenge for companies. Senior executives and the board must decide how to respond, whether it is by engaging with activists in an attempt to resolve the dispute in a mutually acceptable manner or by resisting the activists in a proxy battle. If the company is adequately prepared, it will quickly be able to assemble a response team consisting of executives, board members, and advisers. Then, both ACLN members and experts advise, companies need to take a measured approach that starts with clearly understanding the activist and the situation.

Engaging with an activist

Reflecting on their experiences with activist investors, several ACLN members said that if an activist investor approaches the company, the executives and the board should start by listening closely to understand the activist's concerns and explore ways to address them. Since an activist's insights and ideas could be beneficial for a company, it is important to evaluate them objectively. One member said, *"You always want to listen to them. Also, be brutally honest with yourself about what you are hearing."* Reflecting back on a tough battle with an activist, another member said, *"If you cut through the ugly part, most of the activist's criticisms were correct. They knew what they were doing. And they convinced other shareholders."*

³⁰ Tapestry Networks, Cadwalader, Wickersham & Taft LLP, and Teneo Holdings, [Introduction to the SDX Protocol](#).

³¹ David Gelles, ["Unlikely Allies Seek to Check Power of Activist Hedge Funds," DealBook \(blog\), New York Times](#), February 2, 2014.

³² National Investor Relations Institute, [Board-Shareholder Engagement Survey – 2013 Report](#) (Alexandria, VA: National Investor Relations Institute, October 25, 2013).

Mr. Merrill also underscored the importance of an open mind: *“In general, the more options you can maintain for yourself, the better. Meet with the activist and listen. Get a sense of their ideas and thoughts and concerns. To the extent that they can be addressed and you can avoid a long, distracting and expensive proxy fight, it makes sense.”*

It is also important to meet with the company’s other shareholders as soon as possible. As Mr. Merrill advised, *“You need to know if an activist has a strong hand or a weak hand.”* But he also noted that engagement offers a chance to educate shareholders: *“A lot can be done with diligent shareholder education, so that shareholders have an understanding of and support management’s strategy.”*

Companies should take care to identify the right spokespeople, depending on the activist’s request and the existing relationships with each investor. Mr. Merrill said, *“Being careful how you control that interaction is critical. Typically it’s a lead director who meets with them, or depending on the nature of the activist approach, a director with direct, relevant experience.”*

As with long-term shareholders, direct engagement between the board and the activist may be helpful. One member explained that genuine engagement can deter activists from taking more confrontational tactics: *“An activist takes a position and begins a dialogue with the board about their views, looking for common ground. Only if they find no receptivity do they take a reportable position and solicit the support of other shareholders. If they have to go to plan B, the board has not listened or has been perfunctory in responding. Activists want to take the path of least resistance.”* Mr. Morfit confirmed the point over dinner: *“We don’t look for companies we can bully. If we can avoid going on the board, we would prefer that.”*

Engaging with activists about their concerns and demands can result in a variety of outcomes. The company may agree to undertake certain actions, ranging from minor to very significant, including such measures as declassifying the board, increasing the dividend paid to investors, accepting an activist director or their nominee(s) on the board, or replacing the CEO. Mr. Merrill noted that activists generally do not just walk away: *“They only go away after a productive discussion, bordering on negotiation, where they feel they have been heard and that management has the right strategy. By the time they approach, they have done so much homework, they can’t just walk away. And once their interest becomes public, it’s even harder.”*

Resisting an activist

ACLN members agreed that engagement with activists is not always feasible. As a member explained in a pre-meeting conversation, *“There are investors who think there’s a way to unlock value, and their timeframe is the same as yours, so talking to them is productive. If they are trying to extort you, however, it is not productive to talk to them.”*

If engagement with an activist investor does not seem appropriate or if attempts at engagement ultimately fail, companies should continue to work closely with other shareholders to gain their support. In addition, they should consider other measures for dealing with activist campaigns:

- **Working with proxy-vote influencers.** Although some bemoan the power of Institutional Shareholder Services (ISS), that influence can also work in the company's favor. For example, ISS recently sided with Apple against Carl Icahn's shareholder proposal for a \$50 billion stock buyback.³³
- **Managing the company's image.** Experts recommend that as a company responds to an activist campaign, it should remember that investors and other stakeholders are taking note of its approach and tactics, which could affect how other shareholders evaluate the activist campaign as well as the company's broader reputation.³⁴ For this reason, and others, a member said, *"When you're in a situation like that, be as careful and unemotional as you can."*
- **Using legal defenses.** Boards can also adopt or amend a poison pill plan. Thresholds for such plans are trending down; historically the plans often became effective when a shareholder's stake hit 20%, but over half the poison pills adopted in 2013 had 10% triggers.³⁵ However, Mr. Merrill advised using poison pills only as a last resort: *"If you don't already have one in place, I view a poison pill as more of a nuclear option. It won't curry favor with the proxy advisory firms or with other institutional investors."*

Boards can also eliminate or modify shareholders' right to call a special meeting, give the board flexibility in setting the date of the annual meeting, or change notice requirements for director nominations or shareholder proposals, among other things. But these measures are often only effective in delaying, not stopping, action by an activist. In addition, activist funds may fail to comply with relevant laws, including the rules and regulations promulgated under Schedule 13D of the Securities Exchange Act of 1934, and companies can sue to block some activist proposals.³⁶

Working with an activist board member

Sometimes the outcome of an activist intervention is that the activist secures a seat on the board, either through a negotiated settlement or through a proxy fight in which the activist has managed to secure the support of institutional investors, aided perhaps by the support of proxy advisers. Having an investor activist on the board can be beneficial; for example, Motorola Solutions CEO Greg Brown said that the activists who have joined his board in the last several years, including representatives from Icahn Enterprises and ValueAct, have strengthened the company.³⁷

Mr. Morfit emphasized the breadth and depth of expertise an activist board member can bring by virtue of the extensive research that activists conduct. Alluding to another debate in corporate governance – the issue of board composition – he said, *"We represent a form of diversity. We have nothing to do but follow the company."* He noted that when he joined his first board at the age of 27, *"I couldn't say I had run a company. But I had done the analysis, listened to competitors' conference call, attended trade shows, etc."*

³³ Michael J. De La Merced, ["I.S.S. Sides with Apple in Battle Against Icahn,"](#) DealBook (blog), *New York Times*, February 9, 2014.

³⁴ David Gelles, ["Boardrooms Rethink Tactics to Defang Activist Investors,"](#) DealBook (blog), *New York Times*, November 11, 2013.

³⁵ Liz Hoffman, ["Bitter Medicine in Store for Activists,"](#) *Wall Street Journal*, January 28, 2014.

³⁶ Thomas W. Christopher and Yi Claire Sheng, ["Ten Rules for Dealing with Activist Shareholders,"](#) *M&A Journal* 7, no. 4 (2007).

³⁷ Michael Useem and Dennis Carey, ["An Activist Investor Lands in Your Boardroom – Now What?"](#) *HBR Blog Network*, January 21, 2014.

Lead directors on working with activist board members

At a March 2014 meeting of the Lead Director Network, several lead directors recounted their experiences with an activist board member. The following is an excerpt from the associated *ViewPoints*:³⁸

As boards and management have become more open to listening to activists, members have come to appreciate the benefits that some activists provide. In one member's experience, the activist "Became a really great director and went on to chair a board committee." Another described how the board wanted the activist director to stay even after the activist fund sold its investment in the company. Another member said that activist directors can help act as a catalyst for change: "We never could have changed the CEO pay package without [the activist] pushing. I give him a lot of credit – he said, 'Make me the bad guy.'"

However, not every activist director is helpful. One member said that the wrong activist "Can be disruptive," and described a situation where a "One-sided" activist joined the board, with negative consequences: "Before, the board trusted each other. When someone came in under different circumstances, the board clammed up."

Other members noted the more general benefit of having an investor on the board, whether an activist or not: "On one board, we have a member who is a hedge fund manager who has been wildly informative to the board, telling us what investors would think about [certain actions]."

ACLN members raised some specific concerns with regard to activists who serve on the board:

- **Conflicts of interest.** A member pointed to an inherent dilemma: "*When you're there to represent a specific shareholder, how do you deal with the fact that as a board member you're supposed to look after all the shareholder's interests? That's challenging ... I've seen some very bad behavior.*" Another member added, "*The bottom line is, how will you build trust? Activists often come in with a lot of negative baggage. Can we really view them in the same way we view other board members? Would we put them on the [nominating and governance] committee? I don't think so.*"
- **Encroachment on management.** Defining the line between the board and management is both challenging and important when an activist focused on operations joins the board. As a member of the Lead Director Network noted, "The nature of what some activists do is to seek changes to operations – focusing on things like efficiency, cost, and items in the weeds. That would be dysfunctional if a regular director did it." An ACLN member concurred: "*Your best board members think that it's management's role to run the business. I don't want to be involved ... I don't have the depth of knowledge.*"
- **Insider information.** A member noted that exposure to insider information could be awkward for an activist: "*I've seen some activists leave the board once they understood that they had to deal with*

³⁸ Lead Director Network, "[Dealing with shareholder activism](#)," page 9.

exposure to insider information. They couldn't live with that.” Experts point to a solution for this dilemma: “Many activist shareholders prefer to have independent directors sympathetic to their cause appointed to the target’s board rather than their own officers or employees to avoid being imputed with knowledge of material, non-public information regarding the target’s affairs that would make it difficult for the shareholder to freely trade the target’s common stock and other securities.”³⁹

Indeed, appointing a mutually agreed-upon independent director can also ameliorate conflicts of interest and tensions with management, and many ACLN members prefer this approach even if it means forgoing the benefits of directors who act as “*well-paid consultants I don’t have to pay.*” Clear criteria for nominating and electing board members can help boards ensure that the new member is acceptable.⁴⁰

Conclusion

Reflecting on the past, an ACLN member remarked, “*I knew CEOs who were proud that they didn’t talk to shareholders. I was always amazed at their dismissive attitude.*” Today, the member noted, company executives have a different attitude, and Mr. Morfit argued that a more open approach should extend to activist shareholders as well: “*It’s a partnership you should embrace.*” Activists have more funds and more support from institutional investors, and they are able to target larger companies, often with well-researched and convincing proposals for improving performance. Companies are beginning to prepare more carefully for activist interventions. They are also engaging more closely with activists when they appear, considering their ideas with an open mind, and even welcoming them – or agreed-upon independent directors – onto the board when appropriate.

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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³⁹ Christopher and Sheng, “[Ten Rules for Dealing with Activist Shareholders.](#)”

⁴⁰ Lead Director Network, “[Dealing with shareholder activism.](#)” page 8.

Appendix 1: Guest biographies

G. Mason Morfit

Mr. Morfit is president of ValueAct Capital, a governance-oriented investment fund with approximately \$14 billion in assets under management. ValueAct Capital invests in a concentrated portfolio of public companies and works actively with their executives and boards of directors on issues of strategy, capital structure, mergers and acquisitions, and talent management. The partners at ValueAct Capital have served on the boards of directors of 32 public companies. The firm also has the flexibility to execute going-private transactions for 100% control in select circumstances.

Mr. Morfit joined the board of directors of Microsoft in March 2014. He has been a director of Valeant Pharmaceuticals International since 2007, and the innovative executive compensation structure he designed as chairman of its compensation committee was featured in the *Wall Street Journal* and several academic papers. Mr. Morfit is a former director of CR Bard, Immucor, Advanced Medical Optics, Solexa, and MSD Performance.

Prior to ValueAct Capital, Mr. Morfit worked in equity research for Credit Suisse First Boston's healthcare group, covering the managed-care industry. He has an AB from Princeton University and is a CFA charterholder.

Andy Merrill

Mr. Merrill is a senior managing director at Teneo Strategy. Prior to joining Teneo, he was the US chief executive officer of Finsbury, a strategic communications firm based in London. Mr. Merrill led the build out of Finsbury's US office, focused on domestic and cross-border transaction communications, financial media and investor relations, shareholder activism approach and defense, and crisis communications. He led the ultimate merger of Finsbury's US office with Robinson Lehrer Montgomery just prior to joining Teneo.

Prior to Finsbury, Mr. Merrill led Edelman's 30-person global financial communications practice, which he joined from Abernathy MacGregor, a strategic financial communications consultancy where he was a partner and managing director. Prior to Abernathy, Mr. Merrill was in finance, serving as an investment banker at UBS and as both a senior commercial banker and the head of investor relations for the Bank of New York.

Mr. Merrill is a graduate of Trinity College in Hartford, Connecticut, and has an MBA in finance from Columbia University in New York. He is a member of the board of directors of the Stamford Hospital in Stamford, Connecticut.



Appendix 2: List of participants

The following audit chairs participated in all or part of the meeting:

- Les Brun, Audit Committee Chair, Merck
- John Edwardson, Audit Committee Chair, FedEx
- Gene Fife, alumnus, Former Audit Committee Chair, Caterpillar
- Marie Knowles, Audit Committee Chair, McKesson
- Mike Losh, Audit Committee Chair, Aon and TRW Automotive
- Blythe McGarvie, Audit Committee Chair, Viacom
- Oscar Munoz, Audit Committee Chair, United Airlines
- Guylaine Saucier, Audit Committee Chair, Areva*

The following EY representatives attended all or part of the meeting:

- Tom Hough, Americas Vice Chair of Assurance Services
- Steve Howe, Americas Managing Partner
- Frank Mahoney, Americas Vice Chair of Assurance Services (effective July 2014)

* Member of the European Audit Committee Leadership Network



Appendix 3: Discussion questions for boards and audit committees

- ? What kind of preparations has your company made for activist intervention?
- ? Has your board considered an activist vulnerability assessment? What did you learn from the exercise?
- ? Has your company prepared a team and developed a response plan?
- ? Have you considered shareholder-director engagement as a means of better understanding and communicating with your investors?
- ? What are the most important questions to ask about an activist investor?
- ? What experience have you had with activist-defense service providers (e.g., investment banks, legal advisers, proxy solicitors, investor relations firms)?
- ? What kind of experience have you had engaging with an activist?
- ? In general, what factors will make you more likely to resist an activist campaign?