‘Operational’ activism hits the boardroom

One of the most important trends in governance is the increasing activity of shareholders pressuring boards not on classic governance subjects but on the actual strategic direction or management of the business of the corporation. **By John Madden**

Over the course of this past year, we have continued to see shareholders making their voices heard, in some cases rather forcefully and effectively, on a broad range of corporate issues. In many ways, the recent developments in corporate governance reinforce the growing perception that we are, and have been for several years, experiencing a potentially fundamental shift in the balance of authority, or influence, between boards of directors and shareholders in the corporate decision-making process, moving further away from the longstanding board primacy model of corporate governance.

We remain in the midst of a period of transition in corporate governance in the United States. And it is uncertain how it will ultimately settle out. But one thing is clear: all the changes of the past several years, whether regulatory or market-driven, have focused significantly more attention and pressure on boards of directors.

One of the most important trendline features of 2012 has been the increasing amount of strategic or operational activism. That is, shareholders pressuring boards not on classic governance subjects but on the actual strategic direction or management of the business of the corporation.

Activists have achieved significant success in these efforts at several companies. One of the more noteworthy was Pershing Square's success at Canadian Pacific Railway, where it won seven board seats, out of 16, and forced the replacement of the CEO. And particularly interesting this year has been the willingness of activists to pursue much larger companies that were previously thought to be out of reach for activists. Pershing Square's investment in Procter & Gamble and Relational Investors's stake in PepsiCo are two important examples.

We have also recently seen investors who have not traditionally been viewed as activist now taking more public roles in asserting their views and pressing for change. Paulson & Co.'s investment in Hartford Financial Services is one example. The actions of Qatar Holdings in objecting to the announced terms of the Glencore/Xstrata mega-merger and effectively engaging directly in a renegotiation of the deal's share-for-share exchange ratio stands as one of the more prominent examples of this development. And activists appear to be garnering greater support from a broader range of institutional investors than they generally were able to in the past. Particularly in "short slate" proxy contests, leading proxy advisory firms such as ISS have supported dissidents where they demonstrate that change is preferable to the status quo and that the dissident slate will add value to board deliberations.

Three pressure points

Three particular categories of this strategic or operational activism are the following:

• ***Pressing for Corporate Break-up/Restructuring or Operational Change.*** This category of activism has grown substantially. In particular, underval-

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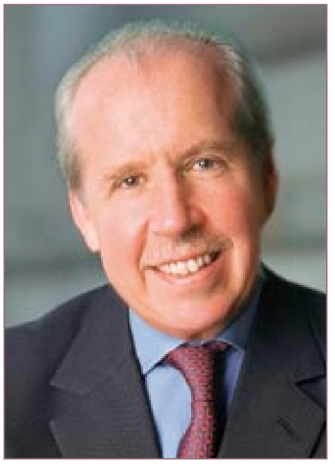

ued companies with multiple business lines have become attractive targets for activists forcing spinoffs or other forms of corporate break-ups. The volume of spinoffs in the U.S. alone in 2011, for example, was six times the volume in 2010. Targets have included companies such as Abbott Laboratories, El Paso, ITT, and Fortune Brands, among others. And recent shareholder efforts for split-ups have developed at companies such as PepsiCo and Ingersoll-Rand. Additionally, activist campaigns seeking to improve management or otherwise address operational aspects of corporate businesses have been initiated at companies such as Procter & Gamble, Office Depot, and State Street.

• ***Forcing the Sale of a Company.*** Activist efforts to pressure companies to put themselves up for sale have also increased. Several such initiatives have been undertaken by Carl Icahn. Targets have included Amylin Pharmaceuticals, CVR Energy, Navistar, Clorox, Charles River Laboratories, Forest Laboratories and, as this edition was going to press, Netflix.

• ***Opposing Announced Deals.*** In the context of mergers or acquisitions announced by corporate boards, shareholders can no longer confidently be expected to follow the board's recommendation. Shareholder opposition to announced deals has surfaced more frequently recently. Qatar Holding's and other Xstrata institutional investors' opposition to the terms of the announced Glencore/Xstrata merger has been this year's most publicized example in this category.

On other activism fronts

In the area of corporate governance activity more generally, some of the noteworthy developments from the 2012 proxy season include the following (the data is derived principally from ISS published reports):

• ***Executive Compensation; Say on Pay.*** Executive pay continues to be a focus of significant investor attention. As in 2011, the 2012 say on pay voting results showed generally strong support for corporate executive pay plans, with some notable exceptions, particularly in the financial sector. At Citigroup, 55% of shareholders voting opposed the pay plan presented. And there was significant minority dissent at NYSE Euronext, Barclays, Credit Suisse, UBS, and Deutsche Bank. Shareholders continued to put forward various proposals on different aspects of executive pay. In fact, compensation-related shareholder proposals increased by 50% in 2012 over 2011, reflecting the return of investors to the use of shareholder proposals, in addition to say on pay, to encourage compensation reform.

• ***Majority Voting.*** Although majority voting in uncontested director elections was ultimately not included in the 2010 Dodd-Frank legislation, it has been aggressively and widely pursued as a shareholder proposal and consistently attracts substantial shareholder support. The percentage of S&P 500 companies with majority voting was practically negligible in 2000; whereas today, nearly 80% have adopted it in some form.

• ***Proxy Access.*** In August 2010, the SEC adopted its Rule 14a-11 allowing qualified shareholders (owning a 3% stake for three years) access to a company's proxy statement to nominate up to 25% of the board of directors. Although the rule was vacated in a court challenge in July 2011, the SEC alternatively made Rule 14a-8 available for shareholders to submit proposals for proxy access on a "private ordering" basis at individual companies. During the 2012 proxy season, 23 such proposals were submitted. Of that group, eight were excluded pursuant to companies' "no-action" requests to the SEC and two were withdrawn pursuant to agreement (in one case, Hewlett-Packard, agreeing to submit the proposal to shareholders next year). Of the 12 proposals that were actually voted on, only two received majority shareholder support (Chesapeake Energy and Nabors Industries); the remaining 10 did not.

• ***Political-Related Activities.*** In the aftermath of the U.S. Supreme Court's 2010 decision in the *Citizens United* case to strike down limits on corporate political spending, SEC Rule 14a-8 is actively being used to call for greater corporate disclosure in this area. With approximately 116 such proposals filed in 2012, political-related activity proposals were the most common proposal seen this year. They received average support of approximately 26% of votes cast.

• ***Chair/CEO Split.*** Shareholders continue to pursue efforts through Rule 14a-8 proposals to split the roles of chief executive and board chair. The number of shareholder proposals seeking independent chairs more than doubled (48 vs. 23) in 2012 over 2011, and support for these proposals rose slightly over that period, from 33% to 36%. Three proposals received a majority of votes cast. The separation of the two roles has generally been resisted by boards, with some deciding to instead designate lead independent directors. Nevertheless, the percentage of S&P 500 companies splitting the two roles has increased from 23% in 2000 to 41% today, with 21% having independent chairs.

• ***Proxy Contests.*** There was a significant increase in the number of proxy contests and "vote no" campaigns this year, compared with 2011. 2012 also saw the emergence of "vote no" campaigns against management say on pay proposals, rather than against director nominees themselves, where shareholders were frustrated with executive compensation at particular companies. Interestingly, the average size of companies involved in proxy contests decreased in 2012, as larger-cap targets continued the trend over the past several years of settling with dissidents before formal contests broke out. — *John Madden*

All these forms of strategic or operational activism have moved from previously being perceived as the focus of a small number of activists to now being seen as more mainstream and broadly accepted methods of influencing corporate direction.

Looking ahead

As we look ahead to 2013, much of what will likely develop in the coming year will turn on the underlying performance of the economy and the financial markets, particularly equity values, as well as on the effectiveness of the increasing engagement by boards with their shareholders.

In the current challenging economic environment, there is no indication that the trend toward increasing shareholder activism will abate, at least in the near term. Through the first half of 2012, the number of large activist campaigns are on pace to be up more than 200% from the 2009 levels and exceed the 2011 levels. And we can expect institutional investors to be increasingly supportive of many activist approaches, particularly in light of recent uneven equity returns. In the area of strategic or operational activism, the focus will likely continue to be on companies with underperforming share prices and on those where business strategies have failed to create value or where boards are seen as poor stewards of capital. And, as in the recent past, there will likely continue to be a focus on companies that are considered ripe for sale or spinoff.

In other areas of traditional governance attention, we should see a continuing focus on shareholder proposals relating to executive compensation, political-related activities and splitting the chair and CEO roles *(see box)*. Majority voting will likely continue to be pressed at those remaining companies still holding to the plurality-voting standard. It remains to be seen whether proxy access proposals will be broadly pursued.

Operational activism is now seen as a more mainstream and broadly accepted method of influencing corporate direction.

Overall, we can expect continuing shareholder activism on several fronts. Accordingly, boards need to be prepared to address activism, when it arises, as effectively as possible. More importantly, boards should think proactively about steps they can take to avoid becoming subject to activist interest in the first place. ■

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