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GOVERNANCE PERSPECTIVES

ACTIVIST OVERTHROWS ENTIRE DARDEN BOARD OF DIRECTORS: WHAT IT MEANS FOR SENIOR MANAGEMENTS

Starboard's 100 percent replacement of Darden Restaurants' board is a landmark activist event. Never before has any board been wholly thrown out of office absent a fundamental financial or operational meltdown. There is little doubt this will embolden activists, and likely stimulate one-upmanship among Starboard competitors. In fact, one can credibly argue that activists were emboldened even before the outcome of the Darden imbroglio was known. Following Labor Day, an abnormally high number of companies across all spheres of size and success received private overtures from activists. Many of these requests contained the same essential message: Undertake to return cash to your shareholders right away, or break up your company or we will take our message public. The timing of this type of request—and the embedded threat—is that if the company fails to respond, the activist has plenty of time to present a competing slate of directors before the target's next annual meeting.

More fundamentally, activism has become a major, permanent investment asset class, and activists no longer target only underperforming or mid-cap companies. In fact, it is not hyperbole to say that almost any company is a potential activist target today.

And so, in all meaningful respects, the annual meeting season has already begun.

The question is, what to do now?

The Darden situation is not alone in teaching that the conventional holy war defensive playbook is ineffective and out of touch. Instead, a more nuanced approach can often be orderly, constructive, and even insightful. Here is our perspective on pursuing a more thoughtful approach:

First and foremost, know thyself. You and your advisors should spend real time looking at your company through activists' eyes. It has been said that activists are "value investors on steroids," ruthlessly economically rational. (They have egos, too.) Assess your company against its peers, and then assess it in isolation. Have you truly achieved organic growth? Has your capital investment strategy paid off as expected? Are you fully putting your balance sheet to work? Once you've done this, schedule time—lots of it—with your board. More on this later.

Second, take a fresh look at how you present your company. Does your road show stump speech really precisely reflect your company and its opportunities, or has it become rote? Do your disclosures do your company justice? Most critically, are you taking on key activist themes—most importantly, smart capital allocation?

Third, cultivate the right shareholders. There are two important points here: that you do in fact cultivate, and that you should be clear-eyed and plainspoken about who *should be* your shareholders. Reach out to your shareholders, and not just at the IR level. Senior-most management and, in the right circumstances, board leaders should spend quality time with your most significant shareholders *before* you ask for their vote. Don't let your lawyers thwart prudent engagement by reflexively pulling out the Regulation FD yellow card; it is not a barrier to engagement, and particularly not a barrier to actually listening. Also, if someone has entered your stock with an investment theory that doesn't fit, you should say so. Over time, you can influence who's invested in your company.

Fourth, eliminate governance issues that invite unwelcome scrutiny. If you have underperforming directors (low meeting attendance, long tenure, underwhelming résumés) or governance practices that are outdated, clean them up. Any perceived governance "foot faults" will be used by activists, with the support of proxy advisory firms, to gain traction on the theme that your board just doesn't get it. This does not mean that you should immediately embark on dismantling every defensive measure you have in place, but it does mean you should retain only those as to which you have a principled—and recently assessed—view.

Fifth, maintain a pool of well-qualified, independent, and available potential director candidates. This is hard. However, our experience has been that when an activist comes calling seeking board change, companies often can achieve a private resolution by not only considering the activist's candidates on the merits, but also by creating a successful compromise that includes one or more of its own new director candidates. Activists want change, and may be agnostic about who embodies that change, as long as it is scored as a win for them. It is important to note here that activists have substantially lifted their game in terms of the caliber of board candidates they nominate. (Witness the Darden slate—the dissident nominees had credible senior-level industry experience, as well as significant diversity.) Often, activist candidates who hail from the corporate world prove to be hardworking, properly motivated directors and even committee chairs at the invitation of their fellow board members. But again, just in case activists nominate candidates who are of a lesser caliber or a wrong "fit" with your board, you should be prepared to counter with a few names of your own.

Last, and most important, actively engage with your board on activism. There is, of course, a meaningful risk that a divide will open up between management and the board in an activist situation because the board will inevitably feel that it is, or is likely to become, a target at the very time that it is important that management and the board work together for the long-term benefit of the company. Management has to be mindful of this and be responsive to director requests but, most important, have laid the foundation so that the board is not thinking through how to respond after the activist has shown up. That's too late. Open dialogue and the introduction of PR and other appropriate advisors to the board are critical to avoiding an urge that directors need to take control of the situation.

When the activist reaches out, remember the adage "Kings to Kings." Do not poke the activist in the eye with a sharp stick, as it will have the expected reaction. This is the ego point already mentioned. Instead, implement a cordial but escalating series of interactions: IR to analyst, CFO to managing director, CEO to principal. There are, or should be, no hard and fast rules regarding meetings with board members, other than that they are not casual events. Ideally, they should be used to bring to closure any preliminary agreements between the activist and the company. In any event, all of these meetings should be characterized by ample preparation, good listening, and a lack of defensiveness.

Moreover, we urge companies to use caution and restraint when considering activists' requests to appoint new board members, return cash to shareholders, or take other significant actions. We agree with the statements made by Ken Moelis, whose advisory firm has represented both activists and targeted companies, in that some companies may be acting too hastily in acceding to activists' demands, which demands may be buttressed by premature or ill-considered advice from investment bankers. But that only works if other steps of a type outlined above have been taken.

We may decry the short-termism inherent in the activism worldview, but the reality is that the market has spoken. Activist investors are here to stay. They have lifted their game. It is time for Corporate America to do the same.

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