Engaging the activists:

Guidance for boards in responding to the new reality of shareholder activism

Shareholder activism is here to stay. As companies adapt to this new reality, we share advice from Fortune 500 board directors, with whom we work closely, on responding to activist investors.

> "Activism is part of corporate life today. It should be expected and anticipated by every company."
>
> **Fortune 500 board director**

Russell Reynolds Associates

“We could not have acted this fast on our own. Maybe activism is not all bad.”

The above quote comes from a board director who approached Russell Reynolds Associates in December 2014 to urgently change the board’s composition in anticipation of an activist campaign. This director’s view reflects changing boardroom attitudes about activism. It suggests a grudging, yet growing, acceptance of this increasingly influential class of shareholder and the potential for activism to bring about positive change. Boards need to be on top of their game—and may need to be strengthened—to deal with activists.

Increasing impact

Shareholder activism has been on the rise for several years. Now at record levels, it has become a major force in developed markets, particularly the United States. Indeed, 2014 proved to be something of a watershed year, witnessing perhaps shareholder activism’s seminal episode to date when Darden Restaurants’ shareholders voted to replace the company’s entire board with activist investor Starboard Value’s nominees. Other high-profile examples, such as Carl Icahn taking on eBay and Third Point winning three seats on the board of Sotheby’s, suggest that this is becoming part of everyday corporate life.

The number of publicly disclosed investments made by activists globally doubled between 2010 and 2013. There were a total of 344 reported activist campaigns in 2014, up 18% from 2013, according to *Activist Insight*. Considering that only about a third of the companies that are approached by activists ever make these overtures public, the true extent of shareholder activism far outstrips these (already staggering) numbers.

Activist funds are attracting the interest of more mainstream institutional investors. Pension funds, in particular, have sought to improve returns by investing with activists. In turn, activist funds have been successful in attracting these investors by championing governance reforms that resonate with all shareholders. Activists also now have considerable experience in rallying support among other shareholders and coordinating proxy votes, endorsed by a host of proxy advisory firms. As a result, 74% of activist demands in 2014 were at least partially successful, according to *Activist Insight* data.

New approaches, new responses

As companies adapt to this new reality, we are seeing a notable shift both in activist tactics and in the skills that boards require in order to respond.

Once viewed largely as self-serving corporate raiders, activists today are just as likely to be viewed as champions of shareholder rights and facilitators of strategic actions. The U.S. Securities and Exchange Commission (SEC) has increasingly espoused the potential benefits of activism. SEC chairwoman Mary Jo White was quoted in late 2013 as saying that the “distinctly negative connotation” of the activist moniker is “not necessarily the current view.”

> "Don't judge activists until you look into them and their style and history. In most cases, they are good shareholders. Engage them, find out what they want and then form an opinion. Activists can be healthy for a company."

In the past, activist initiatives usually began with an aggressive overture to management, in many cases amounting to a demand for a change of control. While this form of shareholder activism still occurs and likely will continue to some degree, today's activists are shifting away from highly personalized attacks toward a more constructive approach. Activists increasingly seek influence to effect positive change in a company's performance based on proposals with defined strategic merit.

More and more, boards are responding to activists through constructive dialogue that addresses legitimate concerns, rather than with a defensive reflex reaction. This heightened willingness to engage with activists potentially can lead to negotiated settlements. For example, The Bank of New York Mellon Corporation, the oldest bank in America, gave Trian Partners a seat on the board in late 2014, joining a raft of companies that have opened the door to activists, thus heading off bruising public fights.

While there certainly are examples of collaborative action with activists, many boards have been forced into making changes. In 2014, 63% of activists sought a seat on the board. This has important implications for the composition and effectiveness of boards. Many companies have re-evaluated and refreshed their boards as a pre-emptive tactic. Nominating/governance committees are oftentimes meeting potential board members with activist experience well in advance of board retirement dates. Organizations are prepared for faster and proactive change of their board members.

All this suggests that few companies are immune to activism either now or in the future. Taking a long-term view and being prepared for an activist approach to join your shareholder ranks are critical.

A road map for success—what all boards should be doing

All companies should be prepared for activism and have a game plan for responding to activists.

Our CEO and Board Succession Practice at Russell Reynolds Associates is increasingly asked to advise CEOs and board directors of companies in anticipation of shareholder activism. The following guidance on preparing for and responding to activist investors is based on our conversations and interactions with board directors across a range of Fortune 500 companies and industries—including oil and gas, chemicals, utilities, consumer packaged goods, leisure, hospitality and financial services.

Before an activist arrives on the scene

Suggested approach:

Track and know your shareholders— Companies should track who is buying their stock to give early warning of a potential activist approach. They also should be working to head off possible problems before they arise by communicating regularly with their shareholders to understand and address any concerns.

Assess your strategy and performance— Analyze your business as an activist would. Ask the tough questions before an activist does and develop a plan to address any vulnerable positions.

Evaluate your board—Activists will demand board seats. By conducting an annual board effectiveness review that assesses process, structure and performance, a board can take pre-emptive action to ensure best-in-class governance and performance. Keep a list of active candidates for the board in the event a change needs to be made.

Formulate an action plan for dealing with activists—Be prepared. Boards should have a basic agreement on their game plan for responding to activist approaches. And if the situation turns combative, boards need to be clear on how they would deal with a proxy fight before it starts. Who will lead the corporate response? What is the message to shareholders and the media? Which internal and external parties will form the response team?

What our clients say:

"Typically, your head of Investor Relations is the first to know when and who is amassing a position in your stock. The CEO should keep the board informed on material investor changes on the buy and sell side."

"All investors are important—you should give them the audience, respect and dialogue they deserve based on their investment position."

"The board and management need to candidly discuss the company's performance and strategic decision making. Conduct an honest self-assessment of your strengths and weaknesses. Then get alignment between the board and management on how you plan to close the performance and/or strategic gaps."

"For boards that don't conduct effectiveness reviews, an activist can be helpful as involvement often will cause disengaged, unprepared or lesser qualified directors to up their game or step off the board. At a minimum, activist involvement will identify the less effective board directors to their peers."

"Every board should keep updated a game plan for reaction to an activist taking a position in the company."

After an activist is detected

Suggested actions:

Act quickly—The company—more specifically the CEO, except in exceptional circumstances—should be proactive about setting up a meeting with the activist investor as soon as their presence is detected.

Evaluate the activist and their proposal—The company should research and understand the activist's track record, industry experience, likely tactics and methods of engaging other shareholders. The sooner the company can determine the activist's underlying motivations and investment proposition, the better.

Gain alignment between the board and the CEO—It is critical that the board and management work hand in hand to determine the appropriate course of action. The activist could use any sign of conflict to their advantage.

Engage and respond—If the activist is collaborative and the proposal has strategic merit, work with them to implement any necessary governance or operational changes. If the company decides to reject the proposal and stay its existing strategic course, it is critical to address any vulnerabilities in the shareholder base to prevent the activist from building momentum.

What our clients say:

"Be active. Being passive is the wrong course."

"Meet with the activist immediately. You have a short window of time before the activist takes the issues public."

"When the activist shows up, figure out what type of activist they are and what their goals are. Do your homework on their past investments and actions. Learn more about the activist than they know about you."

"Management and the board should talk about the issues an activist raises. Do an objective analysis of the proposal. You have to consider what the analysis says without bias and take appropriate action."

"The board and management need to be fully integrated in their consideration and view of the suggestions."

"Hold weekly calls to ensure timely and accurate communication between management and the board."

"The board should keep an open mind and sincerely consider any activist suggestions that are for the benefit of all shareholders."

ABOUT OUR CEO AND BOARD SUCCESSION PRACTICE

Russell Reynolds Associates has introduced the only integrated CEO and Board Succession Practice for corporations and nonprofit institutions across the globe. Our unique integrated structure allows us to uncover strengths and opportunities even when they are not obvious. We evaluate your business holistically and provide a comprehensive view of your leadership bench. We deliver actionable solutions for today's most pressing needs while also helping you anticipate and prepare for future challenges.

For further information and advice on preparing for and responding to shareholder activism, please contact Russell Reynolds Associates.

ABOUT OUR AUTHORS

Clarke Murphy is Chief Executive Officer of Russell Reynolds Associates. Prior to becoming CEO, Clarke led the firm's global CEO/Board Services Practice for five years and has more than 20 years of experience recruiting board directors, CEOs and senior-level executives for leading global corporations.

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ABOUT RUSSELL REYNOLDS ASSOCIATES

Russell Reynolds Associates is a global leader in assessment, recruitment and succession planning for chief executive officers, boards of directors and key roles within the C-suite. With 350 consultants in 44 offices around the world, we work closely with both public and private organizations across all industries and regions. We help our clients build boards and executive teams that can meet the challenges and opportunities presented by the digital, economic, environmental and political trends that are reshaping the global business environment. **www.russellreynolds.com.**

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