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The Role of the Board in Turbulent Times . . .

Avoiding Shareholder Activism

by Damien J. Park and Matteo Tonello

The economic downturn that began in late 2007 has created extraordinary upheavals across global markets and severely penalized stock prices. Today, financial markets supply a number of undervalued companies and investment opportunities, as many businesses maintain relatively strong balance sheets and healthy long-term earnings potentials. As corporate valuations continue to decline, the expectation is that the upcoming proxy seasons will witness an increase in shareholder activism and a new wave of demands for corporate change. In particular, in light of rampant liquidity problems, there is likely to be a shift from the financial-oriented activism campaign aiming at cash extractions to new initiatives pursuing strategic, operational, and governance-related corrections.

This report is the fourth in The Conference Board series “The Role of the Board in Turbulent Times.”¹ It provides board members with a checklist of issues they should consider addressing in their relations with shareholders and, in particular, how to avoid a costly and disruptive battle with an activist investor.

¹ Also see Matteo Tonello, *The Role of the Board in Turbulent Times: Overseeing Risk Management and Executive Compensation*, The Conference Board, Executive Action 292, December 2008; Mark S. Bergman, *The Role of the Board in Turbulent Times: Assessing Corporate Strategy*, The Conference Board, Executive Action 294, January 2009; and Robin Bergen, *The Role of the Board in Turbulent Times: Overseeing Internal Investigations*, The Conference Board, Executive Action 297, February 2009.

The New Economic and Political Context

Several factors suggest that, in the current economic and political environment, shareholder activism will remain a major concern for corporate directors and senior executives.

Capturing market opportunities

The economic recession has had a tremendous effect on the stock market. If compared to their peak value in October 2007, by the beginning of 2009, the S&P 500 and other major indexes were suffering a loss of 50 percent or more

and had reached a record 10-year low.² The downward pressure has not spared business earnings, which have been deteriorating rapidly due to sluggish consumer spending and reduced levels of confidence in the future.³ As a result, the average price-earnings (P/E) ratio of public companies in the S&P 500 index remains high, even for recessionary times. Based on average stock prices and earnings of companies over the past year, the current P/E ratio is about 30, far above the long-term historical average of 16.⁴

However, the current financial context leaves many companies vulnerable as activist investors, like other value shareholders, continue to target those organizations whose prices do not fully reflect business potentials. Despite average market valuations, financial analysts report several examples of undervalued blue-chip companies holding more than \$1 billion in cash, while some of those carry a P/E ratio gravitating around or below 13.⁵ Furthermore, there is evidence that almost 50 percent of companies with a market capitalization above \$50 million are currently trading below their book value.⁶ Traditionally, these metrics have served as the entry point for activist investors seeking to boost share prices. Most recently, activists have been focusing more on ways to unlock hidden pockets of value by pursuing the strategic and organizational corrections that many corporations need in order to adjust to the new economic and political landscape.

Setting new strategic objectives

During the last few years, the typical profile of a target company in an activism campaign would include traits such as excess cash availability and unutilized debt capacity. Often, the activist fund would put pressure on the company to effect redistributions to shareholders (either through dividend payments or by means of share repurchases) or to raise additional debt and use the cash to boost stock performance by funding a payout or a debt/equity swap.⁷

The opportunities to succeed in this investment strategy are drastically reduced by the credit crisis. Due to the limited ability of raising capital in today's market, it will be difficult for activists to argue that cash reserves should be distributed to shareholders rather than retained as a resource to withstand economic stress.

² See Lynn Thomasson, "U.S. Stocks Fall, Sending Market to Its Lowest Close Since 1997," Bloomberg.com, February 23, 2009, also reporting data on the cumulative decline of the Dow Jones Industrial Average and the Russell 2000 Index.

³ See "The Conference Board Consumer Confidence Index™ Plummets Further in February," The Conference Board, Press Release, February 24, 2009.

⁴ David Leonhardt, "Why Stock Still Aren't Cheap," *New York Times*, February 20, 2009.

⁵ See, for example, the statement released by Deutsche Bank Asset Management. Scott Jaffray, chief investment officer, Asia Pacific and Middle East, says: "The current phase of the economic cycle is starting to provide good entry points for value-oriented investors, including those who are keen on blue-chip and large-cap stocks." Ed Peter, head of Deutsche Asset Management for Asia, Australia and Japan, adds: "The crux, however, would lie in differentiating true value from value traps." "Uncovering Gems of Value," Press Release, DWS Investments Singapore, Deutsche Bank, February 17, 2009 (available at www.dws.com.sg/EN/showpage.aspx?pageID=39&detailView=true&newsID=20&originPageID=38). Also see Jeremy Siegel, "The S&P Gets Its Earnings Wrong," *Wall Street Journal*, February 25, 2009, in which the University of Pennsylvania Wharton School professor recommends that, for the purpose of calculating the average P/E ratio of S&P 500 companies, earnings for each company be weighted by the firm relative market weight in the index so as to avoid the distortion where large losses of a few firms outweigh the profits of many other firms. Based on this adjustment in the methodology, the average P/E ratio of companies in the index would be 9.4, well below the 16 historical levels. Finally, see Jason Zweig, "Corporate-Cash Umbrellas: Too Big for This Storm?" *Wall Street Journal*, March 14-15, 2009, in which the author refers to a Strategas Research Partners analysis that 168 out of 419 nonfinancial firms in the S&P 500 have at least \$1 billion in cash apiece, and 16 have more than \$10 billion each.

⁶ Damien J. Park, "Shareholder Activism and Corporate Governance," presentation to the B. Riley Investor Conference, Las Vegas, March 17-19, 2009, based on an analysis completed on March 6, 2009, on file with authors.

⁷ See April Klein and Emanuel Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors," *Journal of Finance*, Vol. 64, No. 1, 2009, pp. 187-229; and Alon Brav et al., "Hedge Fund Activism, Corporate Governance and Firm Performance," *Journal of Finance*, Vol. 63, No. 4, 2008, pp. 1729-1775.

To be sure, investment tactics rapidly adapt to a changing business context, and a number of alternative opportunities are likely to be seized by activist shareholders. Instead of trying to affect financial and capital-structure decisions, activists have begun to focus primarily on those strategic, operational, and organizational adjustments that may be rewarded by the stock market through a share value increase (Table 1, p. 4-6).⁸ On a strategic level, they may try to:

- Propose cost-saving measures or other solutions to improve operational or fiscal efficiency.
- Revise the business plan to reflect changes in external circumstances (for example, by discontinuing a line of products that no longer meets the demands of consumers or by exiting a distant geographical market).
- Seek a change in top management.
- Initiate, facilitate, revise the terms of, or oppose a corporate transaction (for example, a tender offer on another company, a stock sale, or an asset divestiture) with effects on the business direction and long-term results. In a stagnant financing market, in particular, corporate acquirers can take advantage of the reduced competition from private equity firms and pursue growth objectives through strategic acquisitions. Similarly, many investors will continue to target companies reporting net cash on their balance sheet, as they are more attractive takeover targets.

On an organizational level, activists can effect several changes that are likely to be rewarded in the long term by a securities market increasingly sensitive to issues of good corporate governance and risk management.

Among other things, activists may try to:

- Declassify the board of directors by requiring that all members be subject to re-election annually.

- Question the independence or the level of expertise of corporate directors.
- Propose director retirement policies (based on age or tenure) and limits on serving on multiple boards (“over-boarding”).
- Separate the chairman and chief executive officer roles.
- Repeal a shareholder rights plan or rescind other anti-takeover measures.
- Question potential fraud or unethical behavior and demand an investigation.
- Promote new and voluntary disclosure, especially of extra-financial measures of firm performance.
- Strengthen pay-for-performance mechanisms in the executive compensation program.
- Introduce forms of accountability (e.g., the inclusion of “clawback” provisions in compensation arrangements) for those situations in which executives, for the purpose of driving stock price value, deliberately make excessively risky business decisions that are not aligned with the long-term objectives of the company.

According to a report by the chief analyst at The Corporate Library, a governance research and advisory group, in the 2009 proxy season, withhold votes for individual directors are expected to reach an all-time high, particularly for the individuals who serve on those compensation committees that failed to curb pay excesses or on those audit and risk committees that failed in their responsibility to oversee and mitigate the business exposure to uncertainties.⁹

⁸ See, for example, Josh Hyatt, “Getting Smaller, but Not Quieter,” *CFO Magazine*, February 1, 2009; Nicholas Rummell, “Lending Activism His Icahnic Voice,” *Financial Week*, December 8, 2008; and “Why Activist Shareholders Are Gaining Support,” *TheDeal.com*, November 11, 2008. For recently published data on the stock performance of companies targeted by activist shareholders, see Alon Brav et al., “Returns to Hedge Fund Activism,” *Financial Analyst Journal*, Vol. 64, No. 6, 2008, pp. 45–61.

⁹ Ric Marshall, *Proxy Season Foresights #1: What To Expect For Proxy Season 2009*, The Corporate Library, Research Report, February 11, 2009.

Table 1
Active Campaigns

Meetings Scheduled						
<i>Target</i>	<i>Ticker</i>	<i>Activist</i>	<i>Ownership</i>	<i>Demand</i>	<i>Meeting Date</i>	<i>Reason for Pursuing Board Membership</i>
Wilshire Enterprises Inc.	WOC	Bulldog Investors	18.6%	Elect 5 Directors	April 20, 2009	Remove CEO, remove poison pill, liquidate company
Consolidated Tomoka Land Co.	CTO	Wintergreen Advisers	25.9%	Elect 3 Directors	April 22, 2009	Examine Sale Value of Real Estate
CH Energy Group	CHG	GAMCO	8.1%	Elect 3 Directors	April 28, 2009	Details not provided
Charlotte Russe Holdings	CHIC	KarpReilly Capital	8.6%	Elect 3 Directors	April 28, 2009	Board rejected KarpReilly buyout offer; strengthen pay for performance
TomoTherapy Inc.	TOMO	Avalon Capital	4.8%	Elect 4 Directors	May 1, 2009	Improve performance, examine asset sale, institute special dividend or share buyback
Trico Marine Services Inc.	TRMA	Kistefos AS	22.8%	Elect 2 Directors	May 1, 2009	Declassify the board
Online Resources Group	ORCC	Tennenbaum Capital	21.9%	Elect 3 Directors	May 6, 2009	Explore strategic alternatives, separate Chairman & CEO positions
Mac-Gray Corp.	TUC	Fairview Capital	6.4%	Elect 2 Directors	May 8, 2009	Examine a sale and/or dividend payout
Neuberger Berman Dividend Advantage Fund Inc.	NDD	Western Investment LLC	7.6%	Elect 5 Directors	May 13, 2009	Liquidate the company
Neuberger Berman California Intermediate Municipal Fund Inc.	NBW	Western Investment LLC	3.2%	Elect 5 Directors	May 13, 2009	Liquidate the company
Cavalier Homes Inc.	CAV	Legacy Housing, Ltd.	5.0%	Elect 3 Directors	May 19, 2009	Oppose sale of financial services division
Telephone & Data Systems	TDS	GAMCO	9.2%	Elect 3 Directors	May 21, 2009	Disclose purchase offers for the business
Bridgewater Systems	BWC.TO	Crescendo Partners	12.7%	Elect 5 Directors	May 26, 2009	Examine a sale
Biovail Corporation	BVF	Eugene Melnyk	10.8%	Special Meeting; Replace 2 Directors	May 28, 2009	Remove management
Target Corp.	TGT	Pershing Square Capital	7.80%	Elect 5 Directors	May 28, 2009	Spin-off real estate into "inflation-protected REIT"
Canadian Superior Energy	SNG	Palo Alto Investors	9.3%	Special Meeting; Replace Entire Board	June 26, 2009	Examine strategic alternatives

continued...

Table 1

Active Campaigns**Meetings Not Yet Scheduled (as of April 2, 2009)**

<i>Target</i>	<i>Ticker</i>	<i>Activist</i>	<i>Ownership</i>	<i>Demand</i>	<i>Last Meeting Date</i>	<i>Reason for Pursuing Board Membership</i>
Magellan Petroleum, Inc.	MPET	ANS Investments	1.0%	Elect 1 Director	December 6, 2007	Change management and compensation structure
Vanda Pharmaceuticals	VNDA	Tang Capital	14.9%	Elect 2 Directors	April 2, 2008	Liquidate the company
GS Financial Corp.	GSLA	Riggs Qualified Partners; FJ Capital	17.2%	Elect 3 Directors	April 22, 2008	Poor management; Examine asset sale and/or stock buyback
Fisher Communications, Inc.	FSCI	GAMCO	20.2%	Elect 3 Directors	April 30, 2008	Hire i-bank to examine sale; Shareholder approval to acquire anything over \$25M value
Tecumseh Products	TECUA	Herrick Foundation	33.1%	Elect 4 Directors	April 30, 2008	Details not provided
Specialty Underwriters Alliance Inc.	SUAI	Hallmark Financial Services Inc.	9.9%	Elect 3 Directors	May 6, 2008	Board rejected buyout offer
Tollgrade Communications	TLGD	Ramius Capital	11.8%	Elect 4 Directors	May 13, 2008	Board rejected buyout offer
NRG Energy, Inc.	NRG	Excelon Corp.	N/A	Elect 4 Directors	May 14, 2008	Board rejected buyout offer
Cardiovascular Biotherapeutics Inc.	CVBT	Frederic Chanson	24.0%	Elect 11 Directors	May 19, 2008	Remove CEO; Raise additional capital, remove related-party conflicts of interest
Southern Connecticut Bancorp	SSE	Lawrence Seidman	6.5%	Elect 2 Directors	May 20, 2008	Examine a sale to strategic buyers
Aspect Medical Systems	ASPM	First Manhattan Co.	13.6%	Elect 3 Directors	May 21, 2008	Examine a sale
CuraGen Corp	CRGN	DellaCamera Capital	6.5%	Elect 3 Directors	May 21, 2008	Review alternative ways to deploy capital
Enzon Pharmaceuticals	ENZN	DellaCamera Capital	7.6%	Elect 2 Directors	May 22, 2008	Hire investment bank to explore a spin-off of biotechnology business, share repurchase
Cowlitz Bancorporation	CWLZ	Crescent Capital	29.8%	Elect 5 Directors	May 23, 2008	Seeking control
iPass Inc.	IPAS	Foxhill Opportunity Fund	6.7%	Elect 3 Directors	May 29, 2008	Hire consultant to review business plan, change compensation, initiate a sale, declassify board
Amylin Pharmaceuticals Inc.	AMLN	Carl Icahn	9.4%	Elect 5 Directors	May 30, 2008	Examine a sale
Amylin Pharmaceuticals Inc.	AMLN	Eastbourne Capital	12.6%	Elect 5 Directors	May 30, 2008	Improve shareholder value
Advocat Inc.	AVCA	Bristol Investment Fund	6.9%	Elect 2 Directors	June 3, 2008	Remove Poison Pill, de-stagger board, hire bank to review strategic alternatives, buyback
Trans-Lux Corp	TLX	GAMCO	44.3%	Elect 3 Directors	June 4, 2008	Understand the process for valuing and selling entertainment assets
Penwest Pharmaceutical Co.	PPCO	Tang Capital Partners LP; Perceptive Life Sciences	37.5%	Elect 3 Directors	June 11, 2008	Wind-down operations and maximize value from royalties
Biogen Idec Inc.	BIIB	Carl Icahn	5.5%	Elect 4 Directors	June 19, 2008	Board rejected buyout offer

continued...

Table 1
Active Campaigns

Meetings Not Yet Scheduled (as of April 2, 2009)						
<i>Target</i>	<i>Ticker</i>	<i>Activist</i>	<i>Ownership</i>	<i>Demand</i>	<i>Last Meeting Date</i>	<i>Reason for Pursuing Board Membership</i>
California Micro Devices Corp.	CAMD	Dialectic Capital Management	8.6%	Elect 4 Directors	August 21, 2008	Hire investment bank to examine a sale, initiate special dividend restructure compensation
Insured Municipal Income Fund Inc.	PIF	Bulldog Investors	9.7%	Elect 6 Directors	September 3, 2008	Liquidate the company
Lions Gate Entertainment Corp	LGF	Carl Icahn	14.3%	Negotiating for Board representation	September 9, 2008	No reason provided
Trident Microsystems, Inc.	TRID	Spencer Capital	1.3%	Announced intention to nominate Directors	November 21, 2008	No reason provided

Table 2
Settlements

<i>Target</i>	<i>Ticker</i>	<i>Activist</i>	<i>Ownership</i>	<i>Demand</i>	<i>Settlement Date</i>	<i>Settled Terms</i>
Epicor Software Corporation	EPIC	Elliott Associates	13.2%	Buyout offer	February 25, 2009	2 seats on expanded board of 7
Providence Service Corp.	PRSC	73114 Investments	18.6%	Replace entire Board	February 25, 2009	Adopt majority voting policy; Shareholder rights to call special meeting
Actel Corporation	ACTL	Ramius Capital	8.8%	Divest subsidiary	March 6, 2009	3 seats on expanded board of 8
Gaylord Entertainment Inc.	GET	TRT Holdings Inc.	14.9%	Elect 4 Directors	March 9, 2009	2 directors recommended by TRT; increase pill trigger from 15% to 22%
Gaylord Entertainment Inc.	GET	GAMCO	13.4%	Elect 4 Directors	March 9, 2009	2 directors recommended by GAMCO; increase pill trigger from 15% to 22%
Agilysys Inc	AGYS	Ramius Capital	13.0%	Elect 3 Directors	March 12, 2009	2 seats on 9 person board
Pennichuck Corp.	PNNW	GAMCO	11.6%	Elect 3 Directors	March 18, 2009	2 seats on expanded board of 11; increase pill trigger to 20%
Pioneer Natural Resources	PXD	Southeastern Asset Management	19.8%	Improve operations	March 18, 2009	3 seats on 10 person board
Bancorp Rhode Island	BARI	Financial Edge	8.0%	Majority vote policy; elect board annually; reduce board size	March 12, 2009	Adopt majority vote policy; reduce size of board from 15 to 12 over next three years
SciClone Pharmaceuticals Inc.	SCLN	Sigma Tau Finanziaria SpA	21.3%	Elect 4 Directors	March 31, 2009	3 seats on 8 person board
BCSB Bancorp	BCSB	Financial Edge	10.0%	Remove local residency requirement for directors; set floor for options grant	March 20, 2009	Remove local residency requirement for directors; set floor for options grant

Restoring confidence

The economic crisis has eroded confidence in corporate leadership and asset management. In the United States, the turmoil has coincided with a time of profound renewal in the political context and the direction of government. In one of her first public addresses, Mary Schapiro, the newly appointed chairman of the Securities and Exchange Commission (SEC), underscored the role of regulation in correcting some of the shortcomings that emerged in the last few months: “There is much the SEC can do to accelerate the process [of restoring confidence], including giving shareholders a greater say on who serves on corporate boards and how company executives are paid.... Investors are looking to the SEC to protect them. To do that well, we have to act swiftly to respond to market events, and that means we must be willing to change the way we do business.”¹⁰ Today, more than ever, the business and investor communities should recognize the need to be cooperative and proactive in the effort to restore the credibility of capital markets.

Due to public sensitivity to issues of business integrity, good governance, and sound strategic decision-making, activist investors will find it easier to obtain the support of fellow—more passive—institutional investors, on whom they rely to increase their influence on portfolio companies. Indeed, many traditionally passive institutional investors experiencing unprecedented levels of investment fatigue are becoming more vocal in their own right and taking on a new role as “reluctant activists.”¹¹ On the contrary, it will become more difficult for a company to justify the significant expense of conducting a proxy fight to resist activists’ demands.

For these reasons, in the next proxy seasons, analysts expect more corporate attempts to engage with shareholders and settle differences (Table 2, p. 6).¹²

The best approach to both serve shareholders and position companies for long-term strategic independence is to think and act preemptively.¹³ Companies should diagnose the likelihood of attracting activist investors by identifying where activists may see hidden value to be extracted, and plan the course ahead.

Understanding Investors’ Intentions

Corporate leaders should have a full understanding of the intentions and long-term objectives of their larger shareholders. For this purpose, The Conference Board Governance Center recommends that board members encourage senior management to:

- Actively monitor the company’s shareholder base and trading activities regarding its securities, with particular attention paid to large accumulations of stock or extraordinary securities purchase patterns.
- Maintain up-to-date profiles of all institutional investors, asset management firms, or private pools of capital (including private equity groups and hedge funds) with material investments in the company’s securities. Public filings, specialized news services, and public statements by fund managers should be tracked to gather information on the background and specific investment strategies pursued by these entities, including prior investment decisions, history of activism, time horizons, and performance targets.
- Investigate relations between institutional investors and group voting arrangements to determine whether holders are acting alone or in concert with others. Identify “tag-along” investors and shareholders likely to align with an activist fund. In particular, companies should learn how mutual

¹⁰ SEC Chairman Mary L. Schapiro, “Address to Practicing Law Institute’s ‘SEC Speaks in 2009’ Program,” Ronald Reagan International Trade Center, Washington, D.C., February 6, 2009 (available at www.sec.gov/news/speech/2009/spch020609mls.htm).

¹¹ See Kristin Gribben, “Pay Proposals to Dominate Proxy Season,” *Financial Times*, April 5, 2009, reporting that mainstream mutual funds are more willing to back activists this year “because of outrage over mismanagement at some companies.” See also Helen Thomas, “All Activists Are Not Created Equal,” *ft.com/alphaville*, September 13, 2007, based on Damien J. Park, “Understanding Activist Hedge Funds,” (available at www.hedgerelations.com/articles/Understanding%20Activist%20Hedge%20Funds.pdf).

¹² See, for example, Ted Allen, “A Look Ahead to 2009 Proposals,” *Risk & Governance Weekly*, RiskMetrics Group, December 5, 2008; and Ken Squire, “A Golden Age for Activist Investing,” *Barron’s Magazine*, February 14, 2009.

¹³ See Jenny Askfelt Ruud, Johan Näs, and Vincenzo Tortorici, “Preempting Hostile Takeovers,” *The McKinsey Quarterly*, July 2007.

Shareholder Activism, Redefined

Traditionally, shareholder activism has been pursued by means of advocacy initiatives and direct engagement with senior managers rather than by outright proxy contests. This is because trustees and asset managers of public pension funds—the most conventional activist investor type—are subject to stringent fiduciary duties and need to abide by a prudent-man standard of care.^a Even when they do engage in activism, they operate in the context of a highly diversified portfolio. Their stake in the target company remains limited and there is often no economic justification for the undertaking of significant costs in relation to a confrontational activism campaign.^b

Activist retirement funds first adopt and update corporate governance guidelines^c and then promote the advancement of corporate practices on a broad scale by publicly advocating changes in all portfolio companies diverting from those guiding principles. In this process, pension funds tend to rely on the support from influential proxy advisory providers (such as RiskMetrics, formerly Institutional Shareholder Services (ISS)) and shareowner associations (including the Council of Institutional Investors (CII) and the International

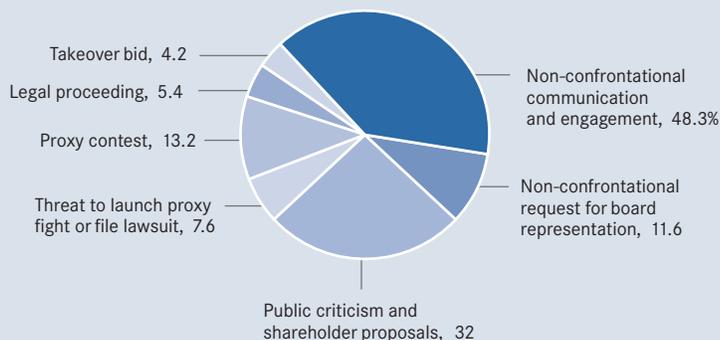
Corporate Governance Network (ICGN)). On their part, mutual funds and other institutional investors can also assume a supporting role by voting proposals introduced by others or adhering to voting policies that are consistent with widely accepted best practices.^d

The rise of activist hedge funds

However, in recent years, hedge funds have shown a growing interest in participating more directly in the decision-making process of their portfolio companies, therefore contributing to a partial redefinition of the activism phenomenon. To some hedge funds, in particular, shareholder activism is truly an investment strategy.

Chart 1

Activism tactics (percentage of total activism events)



Source: National Investor Relations Institute (NIRI), August 2007. Based on a survey of 465 NIRI corporate members.

Note: Percentages do not add to 100 due to concurrent use of multiple tactics.

^a See Section 404(a) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

^b See Fabrizio Ferri, Yonca Ertimur, and Stephen Stubben, “Boards of Directors’ Responsiveness to Shareholders: Evidence from Shareholder Proposals,” AAA 2007 Management Accounting Section (MAS) Meeting, 3rd Annual Conference on Empirical Legal Studies Papers, April 2007 (available at www.ssrn.com/abstract=816264); and William T. Carleton, James M. Nelson, and Michael S. Weisbach, “The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF,” *Journal of Finance*, Vol. 53, No. 4, August 1998, pp. 1335–1362. For an overview of the history of shareholder activism in the United States, see Jay W. Eisenhofer and Michael J. Barry, *Shareholder Activism Handbook*, (New York: Aspen Publishers, Inc., 2009).

^c See, for example, *Policy Statement on Corporate Governance*, Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA-CREF), March 2007, and *Global Principles of Accountable Corporate Governance*, California Public Employees Retirement System (CalPERS), October 2008.

^d On the role of mutual funds in the advancement of corporate governance standards, see Wen-Hsiu Chou, “Do Governance Mechanisms Matter for Mutual Funds?” University of Wisconsin (Milwaukee) Working Paper, March 2007 (available at www.ssrn.com/abstract=972235). For a discussion of how mutual funds may refrain from direct activism due to a number of conflicts of interest (and, in particular, the hesitation to contradict management of a firm that could be a prospective new client), see Gerald F. Davis and E. Han Kim, “Business Ties and Proxy Voting by Mutual Funds,” *Journal of Financial Economics*, Vol. 85, No. 2, 2007, pp. 552–570.

Activist hedge funds tend to acquire larger interests in fewer corporations and demand changes regarding a wider variety of issues (from governance-related improvements to financial corrections and even fundamental strategic changes). They can discreetly engage with management and corporate boards but sometimes are prepared to become hostile (e.g., by launching a voting proxy contest or making a takeover bid) when their requests are not met. In addition, by assuming most of the costs of the campaign for change that it initiated, a hedge fund removes the major obstacle to the activism of other institutions and encourages more traditional investors to tag along, vote in line with the hedge fund proposal, and benefit from it without expenditures.^e To this end, hedge funds can rely on SEC rules permitting the solicitation of the vote of up to 10 additional shareholders without filing proxy materials.^f

Since 2003, in particular, the marketplace registered hundreds of instances of shareholder activism involving hedge funds; in nearly two-thirds of the cases, corporate management either immediately acquiesced in the funds' demands or (after a phase of initial resistance and negotiation) agreed to major concessions.^g More recently, activist funds have not

been immune from the financial tumults; due to their poor performance, many faced redemption calls from investors and some closed their operations.^h However, as the hedge fund industry undergoes a major transformation to adapt to the new economic environment, a larger number of funds might abandon the traditional model (focused on leverage, arbitrage, and day trading) and consider longer investment horizons, as well as how to effectively compete in the shareholder activism arena.ⁱ

In 2007, The Conference Board convened a diverse group of high-level business leaders, asset managers, and governance experts to discuss the corporate response to hedge fund activism campaigns. The Conference Board Hedge Fund Activism Working Group issued its final recommendations in September 2008.^j Those recommendations remain valuable sources of guidance to boards of directors in the current economic and political climate.

^e For an analysis of the so-called "free-rider problem" in shareholder activism, see Roberta Romano, "Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance," *Yale Journal of Regulation*, Vol. 18, No. 2, 2001, pp. 174–252.

^f See Rule 14a-2(b)(2) under the Securities Exchange Act of 1934.

^g Alon Brav et al., "Hedge Fund Activism," p. 1729.

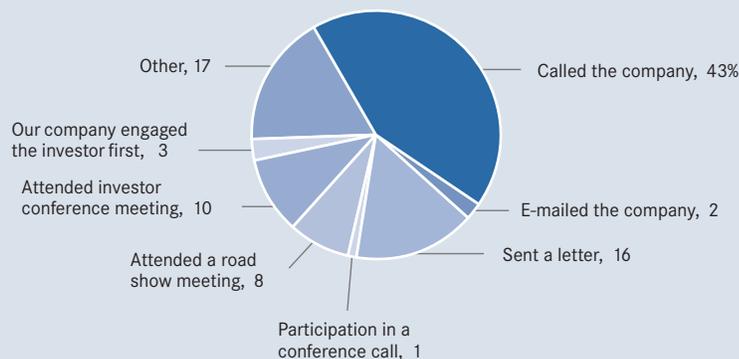
^h For a recent news story, see David Reilly, "Hedge Fund Destruction is the Route to Salvation," *Bloomberg.com*, March 6, 2009, observing that the decline in investment returns reported by hedge funds and, in particular, event-driven and activist funds (19 percent in 2008) remains far lower than the decline of the S&P 500 Index (38 percent in the same year).

ⁱ See Eric Jackson, "10 Reasons to Expect More Activism in 2009," *SeekingAlpha.com*, December 11, 2008. Also see, Martin Lipton, Steven A. Rosenblum, and Karessa L. Cain, "Some Thoughts for Boards of Directors in 2009," *Wachtell, Lipton, Rosen & Katz Memorandum*, December 8, 2009, recognizing that the activism trend of the last decade is "projected to continue its upward trajectory."

^j See Matteo Tonello, *Hedge Fund Activism: Findings and Recommendations for Corporations and Investors*, The Conference Board, Research Report 1434, 2008.

Chart 2

Forms of nonconfrontational first engagement (percentage of engagement instances)



Source: National Investor Relations Institute (NIRI), August 2007. Based on a survey of 465 NIRI corporate members.

funds and other, more passive mainstream investors holding stock of the company vote on certain issues to anticipate possible voting alliances with activists.

- Regularly communicate with the 10 largest institutional shareholders to inform them on the business strategy and new efforts for improving shareholder value. Moreover, if an activist investor discloses an ownership stake in the business, management should meet with its representatives to learn about their expectations. Boards may wish to designate one or more directors to attend such meetings should circumstances warrant. However, senior executives and directors should always consult with legal counsel on regulatory restraints and internal policies on shareholder communication, including compliance with Regulation FD and insider trading (as well as anti-tipping) rules. (See “Regulation FD Compliance,” p. 14). In certain situations, it may be appropriate to request the investor enter a confidentiality agreement (in which case, the company should be prepared for the fund to reject any clause that curtails its freedom to trade or diminishes its ability to seek board representation at a later date).

Outreach as a preventive measure

For a company, a history of positive relationships with shareholders, especially the largest ones, can be the most important asset when an activism campaign is being launched or is in course. Activist shareholders often rely on (as part of their investment tactics) their ability to later obtain the support of fellow—traditionally, more passive—investors. Therefore, establishing a continuous dialogue with these large investors allows management to be sensitive to their concerns and ensure that the current business strategy, as well as financial and organizational decisions the company has made in the pursuit of such strategy, is fully understood.

Confirming its reputation for being at the forefront of corporate governance developments, in June 2007, Pfizer announced the new practice of inviting representatives from investors (owning, in aggregate, approximately 35 percent of Pfizer’s shares) to meet regularly with the company’s board of directors. Pfizer already had used a number of other mechanisms to foster dialogue with all shareholders, including participating in investor confer-

ences and instituting board sessions for reviewing letters and e-mails from investors.¹⁴ This new outreach policy received praise from many commentators. Although the “approach may not be for all boards,” governance experts Ira M. Millstein, E. Norman Veasey,

SEC Rules on Shareholder Communications to the Board

Under the SEC rules on communications between shareholders and boards of directors, companies must provide the following disclosures:

- A statement as to whether the company’s board of directors provides a process for shareholders to send communications to the board of directors and, if the company has not established such a process, a statement of the basis for the view of the board of directors that the process is not necessary.
- If the company has such a communication process:
 - a description of the manner in which shareholders can send communications to the board and, if applicable, to specified individual directors; and
 - if all shareholder communications are not sent directly to board members, a description of the company’s process for determining which communications will be relayed to board members.
- A description of the company’s policy, if any, with regard to board members’ attendance at annual meetings and a statement of the number of board members who attended the prior year’s annual meeting.^a

^a See Item 7(h) of Exchange Act Schedule 14A (SEC Release 33-8340; 34-48825, “Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors,” November 24, 2003). The rules became effective January 1, 2004.

¹⁴ See “Pfizer Board of Directors to Initiate Face-to-Face Meetings with Company’s Institutional Investors on Corporate Governance Policies and Practices,” Press Release, June 28, 2007.

Harvey J. Goldschmid, and Holly J. Gregory released a joint statement in which they predicted that other companies would follow Pfizer's example.¹⁵

In fact, in 2008, other companies experimented with similar forms of direct engagement. Directors of Bristol-Myers Squibb also met with large investors. The board at McDonald's Corp. brought in a panel of outside experts for a half-day discussion on an issue raised by shareholders. Home Depot held a town-hall meeting with shareholder activists and other vocal critics of the company's practices. And Occidental Petroleum arranged a series of road shows to illustrate its corporate governance developments.¹⁶

Addressing Gaps and Vulnerabilities

In these market circumstances, directors should make an extraordinary effort to improve performance and reduce inefficiencies by proactively investigating their company's strategic, financial, and governance-related vulnerabilities. As part of its periodic review of the company's business plan, organizational structure, and operating performance, the board of directors should consider the following actions to minimize exposure to shareholder activism:

- Reassessing strategic goals in light of the new macroeconomic trends that can be detected in the business sector and geographic market where the company operates. While exploring alternative approaches to business growth, the company

should act expeditiously to release any dormant asset or capability that may be impairing the value of the stock and attracting activist investors. For this purpose, directors should remain apprised on extraordinary transactions affecting company peers, customers, and suppliers, and seek a unified consensus on key strategic issues. The board should expect the collaboration of management in monitoring the business portfolio, identifying underperforming assets, and—unless there is a compelling strategic reason for retention—divesting such assets to free liquidity and focus on the core business. Finally, board members should determine whether the market offers opportunities for strategic acquisitions that the company may want, or is in the position, to seize.

- Designating a corporate governance officer who would report directly to the nominating/governance committee or the full board on emerging best practices. Directors should inquire about senior managers' positions on relevant corporate practices and be persuaded by their arguments. If the company chooses to depart from widely accepted organizational standards, such a decision should be thoroughly articulated and motivated in disclosure documents. In particular, directors should revisit any policy—including measures of defense from unsolicited takeovers—that may foster the perception of board entrenchment and stand in the way of garnering institutional support or receiving third-party proxy advisor vote recommendations. (Also see "Updating defense measures," p. 13.) Finally, due to the increased sensitivity in the last few months to issues of executive pay and the possible correlation between forms of incentive-based compensation and certain cases of inordinate risk-taking, directors should conduct a thorough review and assessment of their company's top executive compensation policy to:

- 1 fully understand the possible effects of each single component of the pay package (including bonuses, equity-based awards, deferred compensation, and severance) on the company's decision-making process;
- 2 ensure the right balance between base salary and other components;
- 3 ensure that compensation incentives rely on performance metrics that are appropriately tied to the company's long-term strategic goals; and,

¹⁵ See "Meetings between Directors and Institutional Investors on Governance Matters Are a Constructive Step," Weil, Gotshal & Manges LLP, Client Memorandum, June 29, 2007. See also "Directors Face-to-Face Meetings with Institutional Investors on Corporate Governance Policies and Practices," Wachtell, Lipton, Rosen & Katz, Client Memorandum, June 28, 2007 (available at www.shareholderforum.com/op/Library/20070628_Lipton.pdf) for Martin Lipton's reaction, labeling Pfizer's decision as "another example of corporate governance run amuck" and criticizing the steady escalation of demand for shareholder power that has taken place since 2002, with academic support from Professor Lucian Bebchuk of Harvard Law School.

¹⁶ For an overview of these and other recent cases following Pfizer's example, see Stephen Deane, *Board-Shareholder Dialogue: Why They're Talking*, Issue Report, RiskMetrics Group, February 2009.

4 be persuaded that managers cannot distort the intended mechanics and effects of such incentives to pursue opportunistic behaviors.¹⁷

- Requesting senior financial executives and internal audit officers to promptly bring to the board's attention those financial conditions (e.g., a substantial cash balance or a favorable debt-to-equity ratio) that could make the company attractive to activists (i.e., because it could become the target of a takeover initiative).
- Developing (either in-house or with the assistance of outside experts) an inventory of any corporate matter that may single out the company as a target. The inventory should include foreseeable extraordinary business events that could trigger activists' initiatives (e.g., the announcement of an acquisition or of revisions to the policy for the compensation of top executives).

It is particularly important for boards to take a long-term perspective to value creation by developing strategic initiatives that will reward shareholders on a consistent and lasting basis. In this context, as detailed above, smooth communications with stakeholders are more critical than ever. However, despite efforts to be proactive, sometimes the disparity between the vision of the business pursued by corporate insiders and the positions of an agitating shareholder cannot be overcome. For when this happens, the company needs an action plan to respond promptly and effectively.

Responding to Activists' Demands

Boards should expect to be directly involved with management in formulating responses to requests made by activists. Directors should be prepared to critically analyze (and, when needed, express their constructive skepticism on) management's position. In particular, when activists are critical of current management action or request departure from existing corporate practices, board members should not assume that such initiatives reflect a merely speculative agenda or short-term investment goals. Instead, directors should remain

open-minded and analytical, and review strategic- and governance-related demands in light of the activist's profile and reports on the company published by analysts and rating agencies. Ultimately, the decision should be based on the long-term interest of all shareholders.

Board members and management should agree to an actionable response strategy and, specifically, on whether and to what extent the company should resist or concede to activists' pressures. In crafting its response, the company should pay serious attention to shareholder proposals, in particular if they are of a kind that has received majority support in recent proxy seasons. In those situations, as discussed above, board members and senior executives should proactively engage with the proponents to discuss the rationale for the requested change, even if the company leans toward rejecting the proposal. In fact, the board should be aware that majority-supported proposals are diligently monitored by many fellow activists and that, as a matter of policy, RiskMetrics and other advisory groups recommend a withhold vote when a company fails to be sufficiently responsive.¹⁸

Most important, corporate leaders should be careful in expressing public criticism of the activists' demands and avoid becoming confrontational. Experience shows that such approaches may have a backlash effect and prompt the investor to escalate its hostility and mount a negative publicity campaign against the company (or initiate an outright proxy contest).¹⁹ In particular, by becoming public, the disagreements may bring attention to the campaign and facilitate the promoter's effort to gain the support of other investors.

¹⁸ See Ted Allen, "Postseason Review: Withhold Votes," *Risk & Governance Weekly*, RiskMetrics Group, October 17, 2008. Moreover, The Council of Institutional Investors (CII) has actively followed up with companies that have not implemented investor-backed reforms. Specifically, the investor group has been sending letters urging the companies to adopt the changes or at least convene a board meeting to review the issues. See L. Reed Walton, "Investors Push for Proposal Adoption," *Risk & Governance Blog*, RiskMetrics Group, February 26, 2008 (available at http://blog.riskmetrics.com/2008/02/investors_push_for_proposal_ad.html).

¹⁹ See Thomas W. Briggs, "Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis," *Journal of Corporate Law*, Vol. 32, No. 4, Summer 2007, p. 681.

¹⁷ Also see Tonello, *The Role of the Board*, p. 6.

Updating defense measures

As part of their response strategy, for those situations in which management and directors conclude that activists' requests are not in the shareholders' best interest, companies should consider updating their defense plans against proxy contests or hostile acquisitions. Board members should support management in the advance preparation of such plans to ensure preparedness and flexibility in addressing hostile initiatives.

In particular, the company should review and assess the effectiveness of measures against unsolicited takeover proposals contained in its charter, bylaws, and other organizational documents, including shareholder rights agreements, advance-notice bylaws, and other provisions on shareholders' right to call special meetings.

To avoid adverse consequences with RiskMetrics and other proxy advisory firms, defense measures should not

be designed as entrenchment tools that might be used *a priori* by senior executives to avoid prudent corporate change and merely protect the status quo. Today, supermajority vote requirements, classified board structures, and broadly applicable "poison pills" are widely considered a departure from corporate governance best practices and fiercely opposed by shareholder groups (see "Antitakeover Defenses and Voting Related Issues," below).

However, the opposition regards the indiscriminate use of these devices as a way to shield the company from the market for corporate control, which remains essential to correct management inefficiencies and ensure any needed innovation and change. In light of the current extraordinary circumstances faced by many organizations, many legal advisors recommend that the company should consider updating advance notice bylaws and shareholder rights plans at least to address instances of

Antitakeover Defenses and Voting-Related Issues

The following are the major voting guidelines on shareholder proposals regarding antitakeover defenses published by RiskMetrics for the 2009 proxy season.

Advance notice bylaws To be reasonable, the company's deadline for shareholder notice of a proposal/nomination must not be more than 60 days prior to the meeting, with a submittal window of at least 30 days prior to the deadline. (The submittal window is the period under which a shareholder must file its proposal prior to the deadline.)

Amend bylaws without shareholder consent Vote *against* proposals giving the board exclusive authority to amend the company bylaws.

"Poison pills" Vote *for* shareholder proposals calling for poison pills adopted under a "fiduciary out" provision to be put to a vote within a time period of less than one year after adoption. (A "fiduciary out" provision generally applies in those extraordinary circumstances when the fiduciary determines that it is in the best interest of shareholders to adopt the pill without

the delay that would result from seeking shareholder approval.) In addition, the rationale for the pill should be thoroughly explained by the company. Finally, vote *against* the entire board of directors if the board adopts or renews a poison pill without shareholder approval and does not commit to putting it to a vote within 12 months of adoption.

Shareholder ability to act by written consent Vote *against* proposals to restrict or prohibit shareholder ability to take action by written consent.

Shareholder ability to call special meetings Vote *against* proposals to restrict or prohibit shareholder ability to call special meetings.

Supermajority vote requirements Vote *against* proposals to require a supermajority shareholder vote.

Source: 2009 U.S. Proxy Voting Guidelines, RiskMetrics Group, December 24, 2008 (available at www.riskmetrics.com/policy).

undisclosed derivative/hedging positions (such as cash-settled swaps) or empty voting (i.e., the systematic stock-borrowing by an activist investor for the sole purpose of exercising voting rights and influencing the outcome of a shareholder meeting) or to provide temporary protection from the vulnerability resulting from depressed stock valuations.²⁰

In situations in which there is sufficient evidence that the activist shareholder is operating under an undisclosed understanding with a group of investors or has otherwise violated applicable securities laws, companies should consider notifying the regulatory agencies and be prepared to supplement a public enforcement action by litigating the matter.²¹ The board should also be involved and consult with legal counsel to weigh the costs and benefits of either decision.

Shareholder value and stakeholder relations

To clearly communicate its decision on the response, the company should maintain a unified front and develop a sound and coherent message that can resonate not only with activist investors but also with those other stakeholders with whom the company has key business relations (including employees, customers, suppliers, and the local communities where the business operates).

The message should highlight whether the company will be implementing the requested changes and why the decision is best suited to pursue shareholder value creation. If the company agreed to a settlement discussion with activists for the purpose of correcting strategic deficiencies or financial- or governance-related shortcomings, the message should clearly state the rationale for the negotiated solution.

Since an activism campaign may constitute a serious reputation risk for a business, the company should consider seeking the support of its key stakeholders by ensuring that the motivation for the response underscores not only the company's value proposition as an investment, but also the business' social mission.²²

Regulation FD Compliance

When developing a shareholder communication plan, companies should remember that Regulation Fair Disclosure (FD), under the Securities Exchange Act of 1934, prohibits the selective disclosure of material non-public information. Because of the significant liability that may derive from violation of the rules, boards should seek guidance and education on Regulation FD issues and consider the appropriateness of hiring outside counsel to assist on the proper scope of dialoguing with investors.^a However, an analysis of recent enforcement cases supports the view that Regulation FD is no insurmountable legal obstacle to board-shareowners dialogue, especially on issues of corporate governance.^b

^a See *Framework and Tools for Improving Board-Shareholder Communications*, Council of Institutional Investors and National Association of Corporate Directors, 2004, p. 4; and *Guidelines for Shareholder-Director Communications*, The Business Roundtable, May 2005. Regulation FD is enforceable only by the SEC. However, the same conduct – i.e., selective disclosure of material non-public information contrary to company policy of compliance with Regulation FD – can constitute insider trading in the form of tipping, in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

^b See Stephen Davis and Stephen Alogna, *Talking Governance: Board Shareowner Communications on Executive Compensation*, Millstein Center for Corporate Governance and Performance, Yale School of Management, Policy Briefing No. 2, 2008. The report proposes that the SEC develop a market-wide safe harbor for board-shareowner communications on corporate governance issues to help corporations save unnecessary legal fees and reduce the risk of sanction under Regulation FD.

²⁰ See, for example, Barry A. Bryer et al., "Takeover Risks in Troubled Times," Harvard Law School Corporate Governance Forum, posted January 25, 2009, by Charles M. Nathan; and Martin Lipton, "Some Thoughts for Boards of Directors in 2008," Harvard Law School Corporate Governance Forum, posted December 10, 2007, by Theodore Mirvis.

²¹ For examples of how the mere resistance of the company by suing the activist may be of limited use or even counterproductive, see Thomas W. Briggs, "Shareholder Activism and Insurgency under the New Proxy Rules," *Business Lawyer*, Vol. 50, No. 1, November 1994, p. 112.

²² See Matteo Tonello, *Reputation Risk: A Corporate Governance Perspective*, The Conference Board, Research Report 1412, 2007.

Implementing the response strategy

Boards should become confident that management is fully equipped to effectively implement the response strategy. For this purpose, boards may encourage the formation of a special execution team composed of internal and external specialists (including, for example, finance officers; compliance and governance officers; investor relations and communication experts; general counsel and outside legal counsel; investment bankers; etc.). The team should be entrusted with a protocol of actions to be initiated immediately after the response strategy has been finalized.

In the course of the activism campaign, the board should expect to be kept constantly informed about the response strategy implementation. Management should also consider how to keep employees involved so rumors and speculations by the press or within the organization do not impair the company's ability to attract and retain talent. Similarly, the company's relations with key stakeholders should be closely monitored even throughout the implementation phase so that any concern is addressed promptly.

During an activism campaign, the company operates in a crisis management mode and communication between board members and senior executives is crucial. In no situation should management execute a response strategy that is not supported by the board or depart from the action protocol without first conferring with the board.

The foregoing is not intended to be an exhaustive list of all considerations for boards of directors of companies facing shareholder activism campaigns. This report is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content.

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