Chapter 9

Responding to External Pressures and Unforeseen Events

9.1 The Rise of Shareholder Activism

In the last 3 decades, individual and institutional shareholders found their voice. Today, they assert their power as a company's owners in many ways—from selling their shares to private or public communication with management and the board, from press campaigns to blogging, from openly talking to other shareholders to putting forward shareholder resolutions, and from calling shareholder meetings to seeking to replace individual directors or the entire board.

Although shareholder proxy proposals typically are not binding or may not receive enough votes to pass, they draw public attention to companies' practices and often force them to reconsider their policies. As a result, a growing number of companies meet with their institutional shareholders during the planning stages of a proposal rather than wait until the implementation stage. And an increasing number of companies are submitting all-equity compensation plans for shareholder approval.

In the United States, the birth of the shareholder rights movement can be traced back to the stock market crash of the late 1920s—investors and policy makers believed this disaster was caused in significant part by companies' lack of transparency. In its aftermath, the Securities and Exchange Commission (SEC) was formed and charged with creating public disclosure and enforcement mechanisms to protect investors and promote the dissemination of reliable corporate information to the marketplace.The SEC regulates and promulgates rules governing shareholder resolutions.

In the 1970s, activists' agendas began to include *socially oriented shareholder activism*; religious investors formed a shareholder coalition called the Interfaith Center for Corporate Responsibility (ICCR) and started using the shareholder proposal process as a way of working for peace and social justice. They began organizing and filing resolutions on South African apartheid and community economic development and global finance, environment, equality, international issues, health, and militarism. Today, shareholder resolutions cover a similar range of issues and are used by public interest–minded shareholders and their allies to affect social change on a company level.

Corporate governance activism emerged in the 1980s. This brand of shareholder activism focuses on corporate governance, primarily on how a company structures and compensates its leadership. In 1985, the Council for Institutional Investors (CII) was formed to protect the financial interests of its member investors and pension funds. The CII and its member groups are actively involved in studying and promoting good corporate governance.

One of the most popular shareholder proposals today demands that shareholders be allowed to directly nominate and elect directors rather than work with the slate recommended by the board's nominating committee. Another proposal asks that shareholder resolutions receiving majority support become binding on boards, and that shareholder votes on merger proposals be made mandatory. Support for these further proposals has been lukewarm, however, because they tend to undermine rather than strengthen the role of the board.

In 1989, following the Exxon Valdez disaster, investors and environmentalists banded together to form the Coalition for Environmentally Responsible Economies (CERES), which was built around elements of environmental disclosure. This *investor-environmentalist alliance* uses the power of share ownership to persuade companies to adopt a set of environmental principles and produce public, standardized, annual, environmental reports.

Today, shareholder resolutions are used more than ever as a way of influencing corporate behavior and concern issues ranging from corporate political contributions to health care, from executive compensation to board leadership, and from the environment to animal welfare. Institutional shareholders, especially hedge funds, are a major force behind these developments. Using the power of activism to influence policies at companies in which they have significant holdings, they have begun to scrutinize stock plan dilution, compensation practices, and merger proposals. Mutual fund firms, which have traditionally not been vocal on behalf of shareholder rights, are getting more involved. And more institutions are turning to their most powerful form of activism and voting "no" on key items.

A contributing factor is the short-term boost such efforts can have on stock prices. Thomson Financial studied the performance of stock in 75 companies targeted by activist investors—whether hedge funds, public pension funds, or other entities—between 2001 and 2006. Within the first 3 months of being publicly targeted, the companies on average saw their shares rise nearly 12%, well above the rise of less than 1.5% for a control group of stocks. After one year, the 75 companies posted gains of 17%, compared to a rise of 7.2% in the control group.Thompson Financial (2007).

Not surprisingly, shareholder activism is controversial. Proponents argue that companies with active and engaged shareholders are more likely to be successful in the long term than those that largely function on their own. In their view, vigilant shareholders act as fire alarms, and their mere presence helps alleviate managerial or boardroom complacency. Opponents say that "shareholder activism" is a form of disruptive, uninformed, populist meddling that encourages short-term behavior and diverts a board from a focus on value creation. Some particularly worry about the rise of hedge-fund activism. They note that although hedge funds hold great promise as active shareholders, their intense involvement in corporate governance and control also potentially raises a major problem, namely, that the interests of hedge funds sometimes diverge from those of their fellow shareholders. These polar opposites reflect the broader societal disagreement about how much power shareholders should delegate to corporate boards and when direct shareholder action becomes necessary and on what terms.

9.2 Demands for Corporate Social Responsibility (CSR)

Most of the pressure on boards in the last 25 years has come from shareholders. More recently, however, a different source of pressure—the demand for **corporate social responsibility (CSR)**[1]—has emerged, which is forcing directors into new governance territory occupied by stakeholders other than shareholders. While pressure on corporate executives to pay greater attention to stakeholder concerns and make CSR an integral part of corporate strategy has been mounting since the early 1990s, such pressure is only now beginning to filter through to the board.

The emergence of CSR as a more prominent item on a board's agenda reflects a shift in popular opinion about the role of business in society and the convergence of environmental forces, such as the following:

- **Globalization**[2]. There are now more than 60,000 multinational corporations estimated to be in the world.World Investment Report (2004). Perceptions about the growing reach and influence of global companies has drawn attention to the impact of business on society. This has led to heightened demands for corporations to take responsibility for the social, environmental, and economic effects of their actions. It has also spawned more aggressive demands for corporations to set their sights on limiting harm and actively seeking to improve social, economic, and environmental circumstances.
- *Loss of trust*. High-profile cases of corporate financial misdeeds (Enron, WorldCom, and others) and of social and environmental irresponsibility (e.g., Shell's alleged complicity in political repression in Nigeria; Exxon's oil spill in Prince William Sound in Alaska; Nike's and other apparel makers' links with "sweatshop" labor in developing countries; questions about Nestlé's practices in marketing baby formula in the developing world) have contributed to a broad-based decline in trust in corporations and corporate leaders. The public's growing reluctance to give corporations the benefit of the doubt has led to intensified scrutiny of corporate impact on society, the economy, and the environment, and a greater readiness to assume—rightly or wrongly—immoral corporate intent.
- **Civil society activism**[3]. The growing activity and sophistication of "civil society" organizations, many of which are oriented to social and environmental causes, has generated pressure on corporations to take CSR seriously.The International Chamber of Commerce, a global advocacy group for the private sector, observed in 2000 that "non-governmental organizations have gained an enormous influence" over

1. The pressure on a board of directors in which those directors are forced into new governance by stakeholders other than shareholders.
2. The development or extending of companies on a worldwide basis.
3. The activity of "civil society" organizations oriented to social and environmental causes that generates pressure on corporations to support their causes.

corporate decision making, as quoted in Barrington (2000, January–June). Well-known international nongovernmental organizations (NGOs), such as Oxfam, Amnesty International, Greenpeace, the Rainforest Action Network, and the Fair Labor Association, have influenced corporate decision making in areas, such as access to essential medicines, labor standards, environmental protection, and human rights. The advent of the Internet has increased the capacity of these organizations—as well as a plethora of national and local civic associations—to monitor corporate behavior and mobilize public opinion."Civil society" is sometimes described as the part of society that exists between the state and the market. A more formal definition is "the voluntary association of citizens, promoting their values and interests in the public domain," according to Saxby and Schacter (2003, p. 4). Kaldor, Anheier, and Glasius (2003, p. 2) estimate that there are approximately 48,000 international nongovernmental organizations (NGOs), and that total membership in international NGOs grew by about 70% between 1990 and 2000.
- *Institutional investor interest in CSR*. The growth in "socially responsible investing" has created institutional demand for equity in corporations that demonstrate a commitment to CSR. Recent growth in assets involved in socially responsible investing has outpaced growth in all professionally managed investment assets in the United States, even though the mainstream financial community has been slow to incorporate nonfinancial factors into its analyses of corporate value."Big investors want SRI research: European institutions to allocate part of brokers' fees to 'nontraditional' information," *Financial Times* (UK), October 18, 2004.

These trends indicate that there is both a growing perception that corporations must be more accountable to society for their actions, and a growing willingness and capacity within society to impose accountability on corporations. This has profound implications for the future of corporate governance. It suggests that boards will soon have to deal with

- a growing pressure to give stakeholders a role in corporate governance;
- a growing pressure on corporations to disclose more and better information about their management of social, environmental, and economic issues;
- an increasing level of regulatory compulsion related to elements of corporate activity that are currently regarded as voluntary forms of social responsibility;

- a growing interest by the mainstream financial community in the link between shareholder value and nonfinancial corporate performance.

The discussion about corporate accountability to stakeholders, therefore, while often couched in the vocabulary of CSR, is really a discussion about the changing definition of corporate governance, which is why it should receive a greater priority on the board's agenda.

Interestingly, whereas board agendas mostly focus on competition, cooperation may well become the preferred business strategy for addressing social and environmental issues. Increasingly, companies are joining forces not only with business competitors but also with human rights and environmental activists (formerly considered enemies), as well as socially responsible investors, academics, and governmental organizations. At the 2007 World Economic Forum (WEF) gathering, for example, two such coalitions were announced to address the issue of global online freedom of expression, particularly in repressive regimes. One, facilitated by Business for Social Responsibility (BSR), consists of companies facing intense criticism over complicity with suppressing online free speech in China. This coalition includes big names, such as Google, Microsoft, and Yahoo. The other gathered together socially responsible investing firms and human rights advocates, such as Amnesty International, Human Rights Watch, and Reporters Without Borders.

9.3 Dealing With Hostile Takeovers

Corporate takeovers became a prominent feature of the U.S. business landscape during the 1970s and 1980s. Hostile acquisitions generally involve poorly performing firms in mature industries and occur when the board of directors of the target is opposed to the sale of the company. In this case, the acquiring firm has two options to proceed with the acquisition—a tender offer or a proxy fight.

Tender Offers and Proxy Fights

A **tender offer**[4] represents an offer to buy the stock of the target firm either directly from the firm's shareholders or through the secondary market. The purchaser typically offers a premium price to encourage the shareholders to sell their shares. The offer has a time limit, and it may have other provisions that the target company must abide by if shareholders accept the offer. The bidding company must disclose its plans for the target company and file with the SEC. Sometimes, a purchaser or group of purchasers will gradually buy up enough stock to gain a controlling interest (known as a creeping tender offer), without making a public tender offer. This is risky because the target company could discover the attempted takeover and take steps to prevent it.

Because it allows bidders to seek control directly from shareholders— by going "over the heads" of target management—the tender offer is the most powerful weapon available to the hostile bidder. Indeed, just the threat of a hostile tender offer can often bring a recalcitrant target management to the bargaining table, especially if the bidder already owns a substantial block of the target's stock and can demonstrably afford to finance a hostile offer for control. Although hostile bidders still need a formal agreement to gain total control of the target's assets, this is often easily accomplished once the bidder has purchased a majority of voting stock.

When there are strong differences between a board and a company's shareholders about the firm's long-term strategy, its executive compensation policies, or a merger or acquisition proposal, a **proxy fight**[5] is likely to ensue. This occurs when the board sends out its proxy statement in which it seeks shareholder approval for a variety of actions. Proxy contests are usually waged to replace members of the board of directors, but they can also be used to gain support in other efforts like an acquisition. They tend to involve publicly traded companies but can also target closed-end mutual funds.

4. An offer to buy stock of a firm targeted for acquisition either directly from the firm's shareholders or through a secondary market.

5. The result of a board's sending out its proxy statement in which it seeks shareholder approval for a variety of actions.

A leveraged buyout (LBO) is a variation of a hostile takeover. In an LBO, the buyer borrows heavily to pay for the acquisition, either from traditional bank loans or through high-yield (junk) bonds. This can be risky, since incurring so much debt can seriously harm the value of the acquiring company.

Defense Mechanisms

The management and directors of target firms may resist takeover attempts either to get a higher price for the firm or to protect their own self-interests. The most effective methods are built-in defensive measures that make a company difficult to take over. These methods are collectively referred to as "**shark repellent**[6]." Here are a few examples:

- A *golden parachute*, or change-of-control agreement, is an agreement that provides key executives with generous severance pay and other benefits in the event that their employment is terminated as a result of a change of ownership of the company. Golden parachutes are voted on by the board of directors and, depending on the laws of the state in which the company is incorporated, may require shareholder approval. Some golden parachutes are triggered even if the control of the corporation does not change completely; such parachutes open after a certain percentage of the corporation's stock is acquired.
- The **supermajority**[7] is a defense that requires 70% or 80% of shareholders to approve of any acquisition. This makes it much more difficult for someone to conduct a takeover by buying enough stock for a controlling interest.
- A *staggered* board of directors drags out the takeover process by preventing the entire board from being replaced at the same time. The terms are staggered, so that some members are elected every 2 years, while others are elected every 4 years. Many companies that are interested in making an acquisition are not willing to wait 4 years for the board to turn over.
- *Dual-class* stock allows company owners to hold onto voting stock, while the company issues stock with little or no voting rights to the public. This allows investors to purchase stock, but they cannot purchase control of the company.
- With a *Lobster Trap* strategy, the company passes a provision preventing anyone with more than 10% ownership from converting convertible securities into voting stock. Examples of convertible securities include convertible bonds, convertible preferred stock, and warrants.

6. Built-in defensive measures that make a company difficult to take over.

7. A type of "shark repellent" defense that requires that 70% or 80% of shareholders approve of an acquisition.

In addition to preventing a takeover, there are steps boards can take to thwart a takeover once the process has begun. One of the more common defenses is the adoption of a so-called **poison pill**[8]. Poison pills can take many forms and refer to anything the target company does to make itself less valuable or less desirable as an acquisition. Some examples include the following:

- *A legal challenge*. The target company may file suit against the bidder alleging violations of antitrust or securities laws.
- *The people pill*. High-level managers and other employees threaten that they will all leave the company if it is acquired. This only works if the employees themselves are highly valuable and vital to the company's success.
- **Asset or liability restructuring**[9]. With asset restructuring, the target purchases assets that the bidder does not want or that will create antitrust problems, or sells off the assets that the suitor desires to obtain. The so-called *Crown Jewel* defense is an example. Sometimes a specific aspect of a company is particularly valuable. A pharmaceutical company might have a highly regarded research and development (R&D) division—a crown jewel. It might respond to a hostile bid by selling off the R&D division to another company, or spinning it off into a separate corporation. Liability restructuring maneuvers include the so-called *Macaroni defense*—an approach by which a target company issues a large number of bonds with the condition that they must be redeemed at a high price if the company is taken over. Why is it called a Macaroni defense? Because if a company is in danger, the redemption price of the bonds expands like macaroni in a pot! Issuing shares to a friendly third party—the so-called *White Knight* defense—to dilute the bidder's ownership position is another often-used tactic. In rare cases, a company decides that it would rather go out of business than be acquired, so they intentionally accumulate enough debt to force bankruptcy. This is known as the *Jonestown defense*.
- *Flip-in*. This common poison pill is a provision that allows current shareholders to buy more stock at a steep discount in the event of a takeover attempt. The provision is often triggered whenever any one shareholder reaches a certain percentage of total shares (usually 20% to 40%). This dilutes the value of the stock; it also reduces voting power because each share becomes a smaller percentage of the total
- *Greenmail*. Greenmail is defined as an action in which the target company repurchases the shares of an unfriendly suitor at a premium over the current market price.
- *The Pac-Man Defense*. A target company thwarts a takeover by buying stock in the acquiring company, then launching a takeover.

8. A defensive step taken by a board to thwart a takeover once the process has begun. It can take the form of anything the target company does to make itself less valuable or less desirable as an acquisition.

9. A target company's purchasing of assets that the bidder does not want or that will create antitrust problems for the bidder. A target company may sell off a specific aspect of their company (the "crown jewel") that the bidder regards as highly valuable. Also referred to as *liability restructuring*.

Despite the seemingly obvious advantages, takeover defenses of all kinds lately have become the target of increasingly potent shareholder activism. The primary shareholder complaints against poison pills are that they entrench management and the board and discourage legitimate tender offers. Institutional Shareholder Services (ISS; now part of RiskMetrics Group), an influential provider of proxy voting and corporate governance services, recommends that institutions vote in favor of shareholder proposals requesting that the company submit its poison pill or any future pills to a shareholder vote, or redeem poison pills already in existence. In addition, a company that has a poison pill in place that has not been approved by shareholders will suffer a significant downgrading in the ISS's ratings system. Today, about one third of the Standard & Poor's 500 companies continue to have poison pills.

Shareholder proposals requesting the company to submit its poison pill or any future pills to a shareholder vote, or to terminate an existing poison pill, are not binding on a board—even if overwhelmingly approved by the shareholders. However, if a company fails to implement a proposal approved by the shareholders, there likely will be significant negative consequences for the company and its incumbent directors, including the perception that the company is not responsive to the wishes of its shareholders, substantial withholding of votes in director elections, and downgraded corporate governance ratings.

9.4 The Board's Role in Crisis Management

Crises are inevitable. Large corporations can expect to face a crisis on average every 4 to 5 years. Every CEO will probably have to manage at least one crisis during his or her tenure. A director may have to face two or three crises during a normal tour of service on a board. Crises can take many forms—an industrial accident, product tampering, financial improprieties, sexual harassment allegations, or a hostile takeover. Any sudden event that threatens a company's financial performance, reputation, or its relations with key stakeholders has the potential to become a crisis.This section is based on M. Nadler (2004) and D. Nadler, Behan, and M. Nadler (2006).

Some crises are preventable, others are not. Many are of a company's own making, resulting from sins of commission or omission. In those cases, the board certainly has a role to play in crisis prevention and has clear accountability for failing to faithfully execute its fiduciary duties. A good many crises begin as problems, developing gradually over time, with plenty of opportunities for an alert board to step in and take corrective action.

Nadler (2004) groups crises into one of four categories:

1. *Gradual emergence, external origin*. These might involve economic downturns or the emergence of competitive threats, such as breakthrough technologies, new go-to-market strategies, alliances of major competitors, or regulatory changes that limit business practices or expand competition.
2. *Gradual emergence, internal origin*. Examples range from strategic mistakes (such as a poorly conceived merger) to failed product launches, the loss of key talent to competitors, and employee discrimination suits.
3. *Abrupt emergence, external origin*. Some of the most obvious examples are natural disasters, terrorist attacks, and product tampering.
4. *Abrupt emergence, internal origin*. This can include the sudden death or resignation of one or more key executives, failure of critical technology, production, or delivery systems, or the discovery of fraud.

In the event of a gradually emerging crisis, a carefully designed risk-management process should provide warnings, in plenty of time, for the company either to avoid the problem entirely or to take corrective action before it develops into a full-blown crisis. Abrupt crises are more problematic; no one can predict a terrorist attack, an earthquake, a plane crash, a shooting spree by a disgruntled employee, or a CEO's sudden decision to quit and go to work for a competitor. But sound planning can help the company mitigate the consequences and speed the recovery. The board has an obligation to ensure that management regularly reviews, updates, and practices all aspects of crisis planning.

To deal effectively with any of these scenarios, a board must put together its own crisis-management plan, which identifies the different roles it may have to play depending on management's role in the crisis. The most challenging situation occurs when the CEO is the source of the crisis. This scenario requires identifying what specific role board leaders and individual directors should play, and who the board should call on for independent guidance on legal, financial, or public relations issues.Bremer (2006).

Thus, the board needs to be absolutely clear about how it will be organized during a crisis, which members have particular expertise it can call upon, and who will take the lead in efforts to restore the confidence of employees, investors, and other stakeholders.

Crises Involving the CEO

During most crises, the board has an important but secondary role to play. That is, ordinarily the CEO is the chief crisis manager and communicator, and the board operates in the background to provide oversight, advice, and support. But, as noted above, when the CEO is the cause of the crisis, the board has no choice but to assume the full burden of safeguarding the interests of the company and its shareholders. That situation can arise for a host of reasons. The most obvious is the CEO's death or sudden departure.

To determine who should take the lead in the event of a crisis, the board first must decide whether the crisis creates a real or potential conflict between the interests of management and the company. A hostile takeover bid, for example, may threaten the jobs of senior executives but still be in the best interests of shareholders. In such instances, only the board can provide the necessary leadership to maintain stability in the company and retain the confidence of employees, customers, and investors.

Every board should have a detailed plan for dealing with the sudden and unexpected loss of the CEO. Once emergency succession plans for the CEO and other top officers have been developed and agreed on by the board and the CEO, they should be reviewed and updated at least once a year.

Other Crises: The Board's Role in Supporting and Advising the CEO

Most corporate crises are not about the CEO. Usually, therefore, the CEO will act as the chief crisis officer with the board playing a supporting role—approving key decisions, providing the CEO with a confidential sounding board, giving informed advice based on directors' previous crisis experience or special expertise, and demonstrating confidence in the CEO and support for management's efforts to navigate the crisis.

In a crisis, boards need two things above all else: information and a credible, candid communications policy that keeps shareholders, the media, and everybody else abreast of what is happening. If necessary, boards should launch an independent investigation of what happened and why, and retain their own outside counsel. Constant communication between the CEO and the board is also critical. The CEO must keep the board informed as events unfold and should engage the board in evaluating alternative courses of action. This provides the CEO with the benefit of the board's collective experience with crises at other companies.

Recovery and Learning

After a crisis, the opportunity for collective introspection and improvement is brief because there is an inevitable push to regain normalcy, calm, and control. This is when the board should demonstrate its independence, leadership, and value to the organization by insisting that management stop and learn the most important lessons from its brush with disaster. It also is an opportune time to review, evaluate, and update the organization's capabilities in the areas of risk assessment, crisis planning, and organizational recovery.Myers (2007, January–February).

The bottom line is that, in quieter times, boards could conduct their affairs in a climate of privacy and anonymity. Today, directors are increasingly exposed to all kinds of pressures—from the government, regulatory agencies, shareholders, NGOs, the press, consumers, and ordinary citizens. To deal with this heightened level of public scrutiny, boards must learn to function effectively in an environment of openness and transparency, and learn how to respond to such pressures and to unexpected events.