

COMPLIANCE WEEK

Barbarians At The Gate; Do You Open Up?

By Louis M. Thompson, Jr., *Compliance Week Columnist* — March 20, 2007

An increasing number of companies will experience investors knocking on the board's door asking to meet with the entire board or independent directors to take up their issues.

Board members will want to know and consider:

1. Who are these investors, and what's their agenda?
2. Should the board meet with them? and
3. Do investors have a role in telling the company what it should do to increase shareholder value?

The answer to the first question is to recognize what many already know: Investors are not a homogenous lot, so ask your investor-relations officer to explain who they are, what the size of their holdings is, whether they are long- or short-term investors, and what their likely agenda is.

Investors today come in all shapes and sizes—mutual funds, hedge funds, private-equity funds, pension funds, activist investor funds, and wealthy individuals who have taken a significant stake in the company. Each of these categories demonstrates a wide range of investing behaviors, making the board's and management's roles in communicating with them increasingly complex. In addition, these investors have already shown that they can, at the extreme, cause companies to reconsider fundamental strategy issues—such as selling out, or going private to avoid dealing with a particular investor or group of investors.

The answer to the second question, regarding whether to meet with a particular investor will be primarily guided by the responses to the first question.

In general, ignoring or deciding not to meet with investors is a zero-sum game; not sharing your time with the investor leads to a loss of goodwill on his part. But companies should consider the investor's track record in communicating with the company. An investor who has made no attempt to talk with management but goes straight to the board for the first time does not deserve the same attention as one who has made a number of attempts to communicate with management without results.

Another factor to consider is whether the investor is offering short-term solutions to perceived problems for short-term gains, or ones that could bring long-term increases in shareholder value. The board should consider, in each and every circumstance, how a proposal would affect the company's long-term strategy to build value for all shareholders.

Some companies have established procedures for handling meeting requests with the board or specific directors. One guiding principle is that there are no meetings with investors by either management or the board without the investor-relations officer, the general counsel, or the corporate secretary present to guard company executives or board members from wandering into material non-public information covered under Regulation Fair Disclosure. That is followed by a requirement that the investor has spent time first with management to discuss his or her issues before there is a meeting with the board or selected members. To get a meeting with

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the board, the investor should have a substantial holding in the company—perhaps a threshold like 1 percent or another trigger that the company considers significant.

A consequence that companies should consider when sitting down with one investor or fund is whether this is going to open the floodgates for other investor meetings with the board. There is no evidence over the past several years that this is the case. We could, however, see that—once companies disclose their executive-compensation policies and practices in their 2007 proxies—the current emphasis on executive pay versus performance could cause an increase in requests to meet with the board compensation committee to address these concerns.

The Role Of The Investor

Today, the agendas brought forth by hedge funds and private-equity funds can take on a more strategic direction focused on specific “value enhancing” objectives. Saying to investors that we will sit down with you and listen to what you have to say may provide some interesting input and also avoids a public statement by the investors that “management refused to meet with us!” It also can buy time for management and the board to consider what the company should do next. And finally, the investor might just have a thoughtful idea that is deserving of board consideration.

Hedge funds come in all varieties. Some are in for the quick profit, others have holding periods longer than the average mutual fund (about nine months), particularly if they like what the company is doing. Others want to place one or two directors on the board and play a strong hand in strategic direction. Private-equity funds have arrived on the scene more recently, seeing large amounts of cash on the balance sheet and wanting to put that cash to work by taking the company private or executing financial maneuvers.

In the past, mutual funds voted with their feet; if they didn’t like what the company was doing, they would sell the stock. Some would offer suggestions to companies on strategic direction when they met with management, but normally were not aggressive about it. That’s begun to change with fund managers from Morgan Stanley, Fidelity Investments, T. Rowe Price Group, and Oppenheimer funds, who are meeting with corporate boards. Recently, Morgan Stanley portfolio manager Hassan Elmasry met with the New York Times Co. board asking that investors be allowed to vote on his proxy proposal that the dual-class share structure be eliminated. His proposal has been barred from the proxy.

The public pension funds are more often attempting to influence the governance side of the equation as opposed to capital structure changes or strategic direction. There is the activist investor who will take a large stake in the company and attempt to replace a company’s directors with its own slate. Then, there are the high net-worth individual investors who take a significant stake in the company, demand a seat on the board, and as an insider, then push the board to follow their agenda.

All of this is raising the issue of who is running the store: management, the board, or the investors? Martin Lipton, a noted corporate-takeover lawyer and founding partner of Wachtell, Lipton, Rosen & Katz, recently addressed the Institute on Federal Securities saying that, “Today, shareholder activism is ripping through the boardrooms of public corporations and threatening the future of American business.” He went on to say that shareholder activists are “destroying the role, focus and collegiality of the board of directors.” His comments drew a quick rebuke from *New York Times* business columnist Gretchen Morgenson, who saw this as a positive development for all shareholders “who are trying to make directors more accountable to owners and more watchful over executives.” “Cheer up,” she said. “Your efforts seem to be gaining ground.”

One must say that the efforts on the part of various funds are producing at least some positive results, or investors would give up. A recent study titled “Hedge Fund Activism, Corporate Governance and Firm Performance” of some 900 instances between 2001 and 2005 where activist hedge funds attempted to change corporate behavior, resulted in the stock of the average company outperforming the overall market by 7 percent. Professors from Duke, Columbia, University of San Diego, and Vanderbilt conducted the study.

So, companies now and in the future need to consider all of these relevant factors in creating their strategy and tactics for responding to meeting requests with the board. It’s an issue that’s gaining momentum—and not likely to go away anytime soon.

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[Back](#)