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Barbarians in the Boardroom

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**Activist Directors: Perspectives from Both Sides
of the Board Table**

Recent months have seen a surge in hedge funds and others fighting for board seats at companies in which they have invested. Earlier this year, Kirk Kerkorian won a seat for Jerome York in General Motors' boardroom, Sovereign Bancorp came to terms with Relational Investors, giving a pair of seats, and three directors joined the board of Wendy's to represent Nelson Peltz's Trian Fund. Most agree that this trend shows no signs of abating—"activist directors" in the boardroom are becoming more commonplace in American corporate life.

Public showdowns between activist shareholders and corporate boards can make for high drama. But when the dust settles, and the hard-won prize becomes one, two, or three board seats, how do the directors who join these boards conduct themselves to be most effective? And how do incumbent directors work effectively and resist becoming mired in nasty boardroom brawls that inevitably diminish board, and often company, performance? After all, companies with performance, governance, or capital issues typically attract activists in the first place—they can least afford to have their boards lose focus on the key issues.

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Factors Defining the Rules of Engagement

An activist director's catalytic plan will vary depending on his or her agenda (e.g., company performance, corporate sale or merger, or perceived governance abuses), whether s/he enters the boardroom with a perceived mandate from shareholders (via winning a proxy fight, for example) and by the number of board seats obtained. The first two factors may result in the activist moving to immediate action on a corporate issue; the number of seats may signal how effective the activist director(s) can be. From the activists' perspective, two is always better than one. It allows one director to bring a motion and the other to second it, providing a means to get items onto the board agenda, and force votes on contentious matters.

Credibility: The Ultimate Weapon

Activist directors with a minority of the board seats have only one means of achieving impact in the boardroom: they must build credibility with the rest of the board so as to convince other directors of the need for change. For success in this role the activist director needs patience, persistence, resolve, insight/knowledge relative to company (and peer companies') performance, and the ability to build consensus.

As one seasoned activist director put it: "Barging into the boardroom with all guns blazing" is definitely the wrong approach for such directors, given that their only means of being effective is to get other board members on-side." Initial knee-jerk reactions by incumbent directors can be equally damaging, as the same director explained: "Boards that have not encountered significant shareholder activism in the past often overreact by either entrenching or going too far and agreeing to things they really shouldn't, just to make the dissident go away. Neither is in the best interests of the company."

Building credibility begins even before the activist director enters the boardroom. Members of the board will conduct their own due diligence on the new director, typically contacting members of other boards on which the individual has served to ask questions about competence, capabilities, and working relationships.

An activist director must early satisfy other board members that the focus is on improving the performance of the company for the benefit of all shareholders, not merely serving the interests of the activist's constituent investor. An activist noted: "You don't enter the boardroom at their invitation, so right from the start they are watching to see how you conduct yourself. What is your agenda? They need to see that there is no agenda other than the best interests of the company. The vast majority of directors are well-intentioned people who also want to serve the best interests of the company."

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Credibility is a two-way street. Just as an activist director may be denied it if his agenda is not in the best interests of the company and its shareholders, so too may continuing directors lose credibility if they do not hold those interests paramount in the exercise of their fiduciary duties. A skillful activist can shine a spotlight on these shortcomings, making directors uncomfortable in today's climate of accountability and potential liability.

The Order of Battle

The first order of battle for an activist director is typically company performance. It often begins by identifying one or two of the most important factors contributing to company performance, and getting as much information as possible on these issues. Effective activist directors often do far more homework than anyone else sitting at the board table; some even have large staffs that conduct detailed financial analysis for them and they share this information with the full board and management, building more credibility with fellow board members.

Said a continuing director in reference to an activist peer: "He had MBAs working for him who crunched all the numbers and he'd come to board meetings with charts and graphs that he'd hand out to all of us. It required the kind of time and effort that no one director could possibly put in. I won't say we agreed with everything they did in their analysis, but they did good work and it really added a lot of value for our board to have someone providing this information to us."

The second agenda item for activist directors typically relates to executive compensation. "I always try to get onto the compensation committee as soon as I can," one seasoned activist director noted. "It's better to have people who are uncomfortable with your compensation programs as members of that committee. Otherwise, you are rehashing all the compensation issues in the full board."

Another, who was deliberately kept off of a compensation

Director Summary: With increasing numbers of activist directors winning seats on boards, it is incumbent upon the new directors to build credibility with continuing directors. Both sides must learn to work together, leveraging their talents and contributions for the best interests of the company.

The best directors will raise the level of their game, in response to the activist's deep level of engagement on key issues.

committee, told the board, "Whether or not I'm on the committee, I'm going to continue to do all of my work in analyzing company performance and linking that to management's performance and compensation." He noted, "Soon they realize it's actually better to have you in the tent than outside of it." A third mused, "I think they believe that activist directors are going to be real hawks when it comes to executive compensation. But that's not true. I'm happy to pay people well for good performance. I have problems when people are being paid really well and their performance hasn't been good."

A common third focus area is corporate leadership and succession. Lagging company performance may necessitate new corporate leadership, a board decision that is one of the toughest yet most important. One activist director noted, "CEO succession is well back in the order of battle. But when I get to that point, there are certain red flags for me, such as a CEO who says things like, 'It will take two people to replace me' or if the existing plan involves people who clearly are not ready." Often interim leadership may be necessary while a more permanent solution is developed. Typically, the activist director will look to other, longer-serving board members for insights on the relative capabilities of the executive team to provide interim leadership.

The Other Side of the Board Table

Thus far we have described the order of battle for activist directors. But what about the other side of the board table? What should the incumbent directors be doing while an experienced activist director digs in to try to execute his or her plan for change?

First, they should objectively consider the activist's perspective. As noted earlier, the board's job is to determine whether the activist's agenda is truly in the company's best interests or whether it is simply serving an objective of this particular shareholder. Incumbent directors also need to be cautious not to "give in" to the activist simply as a means of appeasement, something that boards unaccustomed to this type of pressure have been known to do. Even if the other board members do not embrace the activist's plan as a whole, it may nonetheless include some seeds of positive change that they should recognize and consider.

Moreover, incumbent directors should not be content

to evaluate and act only on information developed by the activist and his or her "backroom support." The best continuing directors will raise the level of their game, in response to the activist's deep level of engagement on key issues, rather than abdicating this role to the activist directors. Expert advisory resources are available to boards and can match or exceed the analytical resources supporting activist directors. Moreover, there is nothing stopping incumbent directors from requesting information from management in greater detail even if they have not been accustomed to receiving this in the past. The best incumbent directors will, essentially, become activists themselves, raising the overall level of board engagement, whether or not the activist's agenda is ever adopted.

Patience—On Both Sides

Patience is key. Experienced activist directors note that it can take six to twelve months to build a working relationship with the other directors; add a similar period to make an effective case for change. This requires a balancing act on the part of the activist director. As one director who has represented activist interests on several occasions noted, "You are not there to make a quick buck. You are representing the interests of all shareholders. But one of those shareholders has appointed you because they want to see results. And there is a sense of being under a ticking time clock in terms of when it is realistic for results to be achieved."

The key for corporate boards is to better understand the activist agenda and learn to work effectively with activist directors. The former lead director of a board that was joined by an activist director noted: "The world is changing. We are going to see funds take more activist roles going forward and this trend of funds negotiating board seats will continue. If they put competent, capable people into those seats, the key is to learn to work with them in a way that leverages their talent and contributions, but ensures that board decisions are always made in the best interests of the company and all of its shareholders—not just the interests of the fund who appointed them." ■

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