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Responding to Shareholder Directives to Directors

Posted by Donald C. Ross, Covington & Burling LLP, on Tuesday, May 10, 2016

Editor's note: Donald C. Ross is of counsel at Covington & Burling LLP. This post is based on a Covington publication authored by Mr. Ross. This post is part of the Delaware law series; links to other posts in the series are available here. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here), and Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law and Securing Our Nation's Economic Future: A Sensible, Nonpartisan Agenda to Increase Long-Term Investment and Job Creation in the United States, both by Chief Justice Leo E. Strine (discussed on the Forum here and here).

Shareholder activism, that seeks short-term gain for corporate shareholders, and the response to it by some long term investors, that seek long-term growth in corporate profitability, is creating inconsistent shareholder directives to directors of public companies. At the same time under Delaware corporate law the selection of a time frame for the achievement of corporate goals is a decision of the directors which may not be delegated to the shareholders. This post addresses how directors may seek to resolve these conflicting considerations.

Shareholder activists develop proposals for public companies which are usually designed to increase the near term value of those public companies' shares. Having done so, shareholder activists then purchase minority stock positions in those public companies. To be successful activists also need other shareholders of the target public company to support the activists' proposal. These other investors may be other activists, who act together with the lead activist through conscious parallelism or because they independently agree with the lead activist. They also include other shareholders with a short term investment focus, such as mutual funds[1], and some retail investors.[2] Conversely, other retail investors and institutional investors who own shares for the long term, such as "index" funds, have a long term focus. Long term investors will support activist plans which the long term investors believe will improve a target company's performance and profitability over the long term. Long term investors dislike activist proposals that will maximize a public company's current stock price by sacrificing the company's long term growth and profitability.

An activist usually tries to get its proposal accepted by speaking initially to the board of directors and senior management of a public company to seek their agreement to the activist's plan. To

[1] Leo E. Strine, Jr. "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates also Act and Think Long Term," 60*Business Lawyer* (2010), 10-12.

[2] Robert Moran and Kaylan Normandeau, "Retail Investors Cheer on the Activists." *BrunswickReview: Spotlight on Shareholder Activism*, at 14-16. NY: 924164-4.

strengthen its position an activist will normally also seek the support of other shareholders of the company, of analysts that follow the company and of proxy advisors such as ISS and Glass Lewis. If agreement is still not reached and the activist believes that it has enough support from other shareholders, the activist will run a dissident proxy contest to replace some or all of the directors of the company. If an activist can succeed in electing some new directors the remaining directors will know that they can be replaced too.

A study in 2015 by S&P Capital IQ, carried out for *The Wall Street Journal*, showed that firms in the S&P 500 Index between 2003 and 2013 caused payouts to shareholders to more than double as a percentage of cash flow while their spending on capital expenditures diminished. Some of these changes were initiated by activists. Some were caused by boards of directors acting on their own initiative. In some cases boards of directors acting on their own may have acted preemptively in order to avoid activist attention.[3]

In a recent post[4] Arthur Golden and his co-authors from Davis Polk noted that the boards of directors of public companies are increasingly settling with activists and questioned whether there will be increased scrutiny of boards agreeing to such settlements. They also noted the concern of long term investors that activists rarely seek to have a company "innovate and invest" in long term growth as opposed to seizing immediate opportunities to "divest and distribute" money to shareholders.

The reason why boards of directors are increasingly settling with activists is likely because in recent years activists have increased the number of campaigns they have run against the management and boards of directors of companies and have been increasingly successful. In 2014 there were a record 347 campaigns by activist hedge funds and activists won 73 percent of the battles for board seats.[5] In 2015 activists won 75 percent of their campaigns.[6] Roger Altman of Evercore Partners, who defends companies against activist campaigns, stated recently, "It is a pretty strong hand they [activists] often play, and from the point of view of many boards and management, it is an intimidating hand."[7]

The success of activists and their supporters is causing a reaction among some large long-term institutional investors who want boards of directors and managements to invest in long term growth in corporate profitability and to avoid short term actions which would be at the expense of longer term value-creating investment. The CEOs of long term investors BlackRock and State Street Global Advisors have recently sent letters to CEOs and board members of public companies telling them to develop and publish their plans for long term value creation for their businesses and to manage their corporations in accordance with those long term plans. In recent posts Martin Lipton and his co-authors from Wachtell Lipton provided copies of these letters,

[3] John C. Coffee, Jr. and Darius Palia, "The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance," *Columbia Law School Working Paper No. 521*, September 4, 2015, pp. 60-61.

[4] Shareholder Activism & Engagement 2016 posted by Arthur F. Golden, Davis, Polk & Wardwell LLP, on March 14, 2016.

[5] Coffee and Palia, Op. Cit. 16

[6] Remarks made on March 16, 2014 at the Tulane University Law School's 28th Annual Corporate Law Institute in New Orleans, as reported in Law 360, March 17, 2016.

[7] Id.

general advice as to how to comply with them and called this approach, “the new paradigm for corporate governance.”[8]

As a result of these events the boards of directors of U.S. public companies are being caught between the activists and their supporters who threaten to replace directors that will not implement the activist’s proposals focused on short term gain and some long term investors who say they will use the proxy voting process to replace directors who will not develop, publish and manage to a long term plan.

The corporate law tells directors that they (and not the shareholders) are the people legally charged with the duty of deciding the corporate strategy and its timing:

“Delaware law confers the management of the corporate enterprise to the stockholders’ duly elected board representatives, *8 Del. C. § 141(a)*. The fiduciary duty to manage a corporate enterprise includes a selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders.” *Van Gorkom*, 488A. 2d at 873.[9]

In the same decision the Delaware Supreme Court also rejected undue emphasis on the long-term and the short-term:

> “While we affirm the result reached by the Chancellor, we think it unwise to place undue emphasis upon long-term versus short-term corporate strategy. Two key predicates underpin our analysis. First Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation, *8 Del. Ch § 141(a)*. This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of “long term” versus “short term” value is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon. Second, absent a limited set of circumstances defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under a per se duty to maximize shareholder value in the short term, even in the context of a takeover.”[10]

While Delaware courts have assigned the task of establishing corporate goals and their time frame to the directors, the directors also know that it is the corporation’s shareholders that elect the directors.[11] This fact is likely to cause the directors to consider how a majority of the shareholders will want the corporation to be managed by the directors when the directors decide which corporate goals and time frame to select. As Chief Justice Strine has pointed out in his non-judicial writing:

[8] Succeeding in the New Paradigm for Corporate Governance posted by Martin Lipton, Wachtell Lipton, Rosen & Katz on March 15, 2016.
[9] *Paramount Communications Inc. v. Time Inc.,* 571A. 2d 1140, 1154 (Del 1989)
[10] Id. 1150.
[11] Delaware General Corporation Law, § 211(b)

> "It is jejune to demand that CEOs and boards manage for the long term when the stockholders who can replace them buy and sell based on short-term stock price movements, rather than the long-term prospects of firms."[12]

How then should directors of U.S. public companies respond to shareholder demands for short term and long term returns and also comply with their fiduciary duties under the current legal regime?

Since at least the leading case of *Guth v. Loft Inc.* 5A. 2d 503 (Del. 1939)[13] was decided, directors and officers have been held by the Delaware Supreme Court to stand in a fiduciary relationship to the corporation and its shareholders. The directors and officers are required to protect the interests of the corporation and refrain from doing anything which would injure it or deprive it of profit or advantage. The Supreme Court of Delaware has also stated in a number of subsequent cases that directors must act in the best interests of the corporation and its shareholders.[14] In the most recent of these decisions, *Gheewalla*, the court also explained that, "directors … discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interest of the corporation for the benefit of its shareholder owners."[15]

In evaluating compliance with this fiduciary standard of conduct the Delaware courts employ the standard of review of the business judgment rule. Under the business judgment rule a decision made by a board of directors is presumed to be made on an informed basis, in good faith and in the honest belief that the action taken is in the best interests of the company unless a plaintiff can plead facts giving rise to a reasonable inference that the board did not act on this basis. Otherwise, "… the court merely looks to see whether the business decision made was rational in the sense of being one logical approach to advancing the corporation's objectives."[16] This standard of review provides directors with broad discretion to decide what is best for the corporation and its shareholders.

It is difficult for a plaintiff to rebut the presumption underlying the business judgment rule at any time and particularly when a board's actions are taken in the present and the effects of those

[12] Op. Cit. 17

[13] 5A. 2d 503 (Del. 1939)

[14] *Bay Newfoundland Co. v. Wilson & Co.,* 37A. 2d 59 (1944) (a director "owes a duty to both the corporation and the stockholders"); *Good v. Aronson,* 473A. 2d 805 ("The existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders");*Polk v. Good*, 507A. 2d 531 (Del. 1985) ("directors owe fundamental fiduciary duties of loyalty and care to the corporation and its shareholders"); *Revlon. Inc. v. MacAndrews & Forbes Holdings, Inc*., 506A. 2d 173 (Del. 1986) ("In discharging this function the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders"); *Mills Acquisition Co. v. MacMillan*, Inc., Del. Supr., 559A. 2d 1261, 1280 (Del. 1988) ("While these goals may not have constituted prima facie breaches of the duty of loyalty owed by senior management to the company and its shareholders…"); *Cede & Co. v. Technicolor*, 634A. 2d 345 ("directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders"); *Malone v. Brincat*, 722A. 2d 5 (Del. 1997) ("This Court has endeavored to provide the directors with clear signal beacons and brightly lined-channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders"); *N. Am Catholic Educ. Programming Found., Inc v. Gheewalla*, 930A. 2d 92, 100 (Del. 2007) ("It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders" and "directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.")

[15] *N. Am. Catholic Educ. Programming Found., Inc. v. Ghewalla*, 930A. 2d 92, 100 (Del. 2007).

[16] *Quadrant Structured Products Co. Ltd v. Vertin*, 102A. 3d 155, 183 (Del. Ch. 2014)

actions are speculative because they will occur in the future. If the action being considered by the board has a rational business purpose it will satisfy the business judgment rule, unless one of its other elements is rebutted. The broad discretion given to a board of directors under this standard is the likely reason why settlements made by directors with activist shareholders are not being challenged in class actions by other shareholders who want corporations to be managed for the long term.

There are four potential general kinds of approach which a board of directors could choose to follow in these circumstances. A board of directors could:

- operate the company to emphasize short-term profit and distribute much of it to the shareholders at the expense of investment for long term growth in profitability;
- innovate and invest to maximize long term corporate profitability and pay out little or no cash to shareholders;
- choose the corporate strategy the board considers best for the corporation and its shareholders and accept the resulting time frame without regard to shareholder wishes; or
- set corporate goals and behavior to generate a balance of short term and long term returns to respond to conflicting shareholder demands and manage the corporation to increase corporate profitability within these limits.

The facts and circumstances of the business of each corporation and the attitudes of its shareholders will influence the thinking of the directors in deciding what to do in each case. Any of these approaches may be adopted by a board of directors under the business judgment rule if the approach can be justified in the circumstances as one logical approach to advancing the corporation's objectives.

The annual disclosure of a number of public companies indicates that they have both a long term plan designed to enhance their future profitability and a short term plan to return some cash to shareholders through dividends and repurchases of the corporation's stock. This approach responds to all of the pressures and legal obligations to which public company boards are presently subject.