

## THE RISE OF ACTIVIST INVESTING – AND HOW TO RESPOND

A CITIGATE WHITEPAPER

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### A. What is “Activist Investing?”

What is “Activist Investing?” There are many terms used to describe the phenomenon, but measured by investment objective, investment horizon, level of activity, methods of communicating, and means of action one could make a distinction between shareholder activists, active shareholders, and activist investors.

#### 1. Shareholder Activists

Shareholder activists are shareholders who pursue sustained social or ethical campaigns by all kinds of means, sometimes also by buying stock and exercising shareholder rights. In essence, the term refers to ethical or political pressure groups that are entering the listed company arena for greater attention or to fight the system from within.

Shareholder activists may pose a significant threat to a company’s financial well-being if and to the extent their criticism relates to a company’s business as such and is based on shared fundamental belief or values. The broader the voiced concerns are shared, the greater the effects of the campaign. Successful implementation of a shareholder activist campaign does not only affect short-term sales, but may result in capital markets discounting negative perception and uncertainty mid- or even long term.

Experience shows that ethically motivated shareholder activism,

including demands for better corporate governance, does rather not employ corporate or legal action. Until today shareholder activists are using their right to speak at general meetings to denounce companies of employing child labor, of polluting the environment in under-developed countries, or to oppose certain products or an organization’s value system. These activities may be of tolerable nuisance value from the company’s perspective but should remind us that the peace movement of the 1980ies could easily have taken over and subsequently dissolved listed weapon manufacturers; the same applies to the green movement and nuclear power producers.

Corporate governance campaigns are different in that they can be motivated by ethical thought or by business interests. How should a company be managed? What should the system of checks and balances look like? Who should be accountable to whom? What level of participation and transparency is owed to which constituency? Who should have what share in the profits? These questions have both an ethical and a business dimension.

Ethically motivated governance campaigns are usually of limited impact. They address a much smaller audience than product focused campaigns: Actual and potential investors, not millions of consumers. What is more, the non-financial benefits of good governance are difficult to measure, let alone prove. It is the ethical dimension, however, that makes the governance angle prone to abuse. Corporate governance campaigns become questionable if investors advocate the benefits of good governance for all but mean short-term financial gain for some.

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<sup>1</sup> Views expressed are those of the author.

## 2. Active Shareholders

Why are shareholders who used to be fairly passive for decades turning active, going vocal, or even taking an activist stance? There are three trends that appear to further the rise of activist investing, namely: Passive investing being on the decline; shareholder awareness and assertiveness generally increasing; and large pools of capital being earmarked for non-traditional investments and competing for too few alternative investment opportunities.

In the old times, many institutional investors were predominantly passive. They pursued an overall, diversified long- to mid-term, hands-off portfolio strategy, held an observer status and reacted to fundamental changes only – the archetype of the value investor. There used to be a large group of passive observers who had limited communication with the company and only remote contact with other shareholders, and a much smaller group of active observers who had regular albeit decent communication with the issuer and who cultivated some exchange with other shareholders.

Passive investors invest and divest, engage to some extent in non-public shareholder dialogue, and typically exercise their votes in favor of management or abstain from voting. When communicating with the company and/or other shareholders, the passive (or more traditional or value) investor seeks to obtain information and an exchange of views regarding the company's long-term strategy, fundamental value drivers and critical success factors, rather than influence the company's immediate plans or actions. The passive investor sells part or all of his shareholding when the company's strategy or performance is no longer in line with

his overall expectations or risk/return profile. He does not normally take short positions himself but may occasionally lend shares for a fee to short sellers. He rarely initiates corporate action but may in exceptional cases indicate to management in private that supporting shareholder proposals initiated by other shareholders at a general meeting would be an option. The passive investor almost never instigates legal action.

These times are gone. Shareholder assertiveness is increasing, and the old paradigm "if you don't like management, sell your shares" is no longer valid. While it is true that none of the many studies on this subject provided sufficient evidence for a causal connection between the quality of corporate governance and long-term performance of the stock generally, it is also true that there exists a strong link between stewardship and performance in specific situations. Prior to exiting the position, an increasing number of shareholders would therefore try to be heard and if need be assert their rights as shareholders (rights to information, exercise of voting rights, or even standing to take corporate or legal action).

In an ever-changing investment climate, even the more traditional (rather passive) investors must be expected to turn active and become an active shareholder in a given situation. Turning active means an increased level of activity, in fact any sustained activity except activist investing: A passive observer who starts asking questions during an analyst conference call, thus transforming into an active observer; an active observer becoming a vocal shareholder by expressing his views in writing to senior management or his opposition of management (or its

actions) before a greater audience such as analyst conferences or even in the media; or an active investor who starts supporting activist investors's views or even corporate or legal action, thereby taking an activist stance in a specific situation himself.

A prominent example perhaps is traditional German *Deka* bank's role in *Wella*, where *Deka* signed a motion initiated by a hedge fund to appoint a shareholder representative to the *Wella* supervisory board – much to the dismay of *Procter & Gamble* who had just taken over *Wella* (but had initially offered different prices for different classes of shares). In 2005, this signature earned most conservative institution *Deka* an entry in a *Citigroup* report "Hedge Funds at the Gate" among the 25 most notorious hedge fund activist campaigners of the year.

But after *Wella*, the trigger event that proved that big-ticket event-driven investing was possible, and *Deutsche Börse*, the trigger event that proved that the seemingly unthinkable was achievable, the landscape has changed forever towards a new paradigm: If shareholders don't agree with how the company is being managed, they will use their shares to bring about change. An active, hands-on approach to investment is likely to become the norm. More and more financial institutions are taking pride in being described as acting assertively on behalf of their investors to which they owe a fiduciary duty to earn risk-adequate returns on investment – which they in fact do.

### 3. Activist Investors

Activist investors are typically investment funds which pursue a specific, hedged, short- to mid-term investment thesis that relates solely to

the stock of the company or the industry in which the company operates, taking an activist stance vis-à-vis senior management, often in public and using the media, to accomplish their financial objectives.

When communicating with constituencies other than senior management (supervisory board/outside directors; works council; analysts; shareholders's associations; financial press, etc.), the activist investor seeks to shape investor sentiment and mobilize shareholder opinion so to influence the company's immediate plans or actions in line with his investment thesis.

He trades in and out of the stock opportunistically and often takes short positions in addition to long positions; he may go short-only. He may well take corporate and even legal action where available, and sometimes for the sole benefit of creating nuisance value.

Activist investors can be compared to arbitrageurs in that their activity revolves around a corporate event (M&A, capital increases, issuance of a bond, etc). Activist investors are different, though, in that merger arbitrageurs try to lock in a takeover premium while activist investors speculate on a possible future event that would act as a catalyst and become active to make the catalyst event happen that unlocks value which can then be harnessed through trading activity. In the words of the *Hermes Focus Fund*, an investment vehicle of the *British Telecom Pension Scheme (BTPS)*, *Hermes* invests "in companies that are fundamentally sound but whose shares are discounted by the market as a result of strategic, governance or financial structuring weaknesses and where shareholder involvement can be the catalyst for change and result in improved performance."

In a transactional context, for an investor who went long in the target company's stock following a bid announcement, a typical "catalyst" event would be an offer price increase (or a higher competing bid); the activist investor would then campaign for a higher offer. Other catalyst events could be, *e.g.*, leveraging or de-leveraging of the balance sheet, a decision to divest a substantial part of the business, a forced merger, or a management change.

## B. Strategy

The company's actual performance may or may not be relevant for an activist investor's investment thesis. In transaction based strategies, performance tends to be less important because the value sought is generated by and extracted from the situation. Underperformance is certainly helpful when the objective is to replace sub-par management; outstanding performance may be taken as an invitation to milk cash out of the target company. In all mentioned situations, activist hedge funds seek and often find "alpha."

### 1. "Alpha," "Value," "Short-Termism"

The term is commonly used to describe an excess return on investment which is based on a specific skill set and that is uncorrelated with market or economy-wide returns. The ability to identify mergers that will succeed or fail, irrespective of market risk (beta), would form a relevant skill ("*edge*"). To accomplish alpha, the fund establishes one or more investment hypotheses which then form an investment strategy: Go long in strong merger A, go short in weak merger B, employ leverage.

Most strategies are either capital structure or transaction related: A fund

may, *e.g.*, try to influence the company's decision making process to increase capital distribution by paying out excess cash, taking on debt, monetizing low growth assets, or stripping other assets; or/and apply various long or short strategies (strategic block/greenmail; frustrate M&A or capital measures).

Depending on a fund's investment style, one will find different return expectations, appetite for risk, and investment horizons. Most funds are trying to minimize risk. Since many funds active in Continental Europe have dedicated vehicles (or separated cells) for special investments in Europe or in Germany specifically, several funds must be expected to be able to hold out for two years or longer.

Activist investors are almost always looking for short-term financial gain, be it cash payments or a significant appreciation of the share price. Typical targets are undervalued companies with excess cash and potential for leverage or divestitures.

In this context, whether or not a company is "undervalued" depends less on fundamental or technical analysis but rather on market perception. Value may be fundamental, or a "reflexive" function of fundamentals and perception (*Soros*), or be perception based only – for the trader it does not matter whether or not there will be a fundamentally sound basis for an increase in share price, if only there is potential for such increase for a long enough period of time because of a sufficient number of market participants buying into the argument.

Another frequent source of misunderstanding is the interpretation of "short-term." Many corporates would like their stock to be viewed as long-term growth stock that is best held

onto over a full capital market cycle, *i.e.*, five to twelve years. From this angle an investment horizon of up to one year may indeed appear to be short-term and of up to three years mid-term. At the same time, the average holding period within the global mutual fund industry is between ten and twelve months, depending on cycle stages. From a mutual fund manager's perspective four months may be short-term, eight months mid-term, and twelve and more months long-term; some but by far not all would be considered by their peers as long-term traders (*e.g.*, position or momentum traders). On closer examination, investment horizon as such is rarely indicative of "short-termism."

Activist strategies are increasingly melting with buy-out strategies, creating a threat for companies to be taken over by a combination of hedge fund money and buy-out fund expertise ("pirate equity").

## 2. Transaction Based Strategies

Next to mergers and acquisitions, transaction based strategies revolve around events that are likely to trigger future cash compensation, such as the conclusion of a domination and profit and loss transfer agreement; a squeeze-out under the Stock Corporation Act; a "cold" delisting (transformation into a corporate form that cannot be listed); or a formal delisting.

In most events, compensation owed will be determined either by German CPA Institute IDW's "S1" valuation standard or by the average share price for the three months prior to the respective shareholders' resolution, whichever the greater. Activist shareholders know that, according to German minority shareholders' association *SdK*, out of 282 proceedings

for the determination of fair cash compensation only 38 did not result in a higher compensation. A typical increase would be between 20% and 40% (with an empirical maximum of 726%).

Structural measures, such as the implementation of a domination agreement, are often key for the successful bidder to fully integrate the target company. Activist shareholders may oppose the conclusion of such an agreement so that the bidder cannot realize synergies from the transaction, or cannot sell-off assets to refinance the transaction, or cannot effect necessary antitrust disposals. For all these measures the acquirer needs a 75% capital majority under German corporate law. To become eligible for tax consolidation in the U.S., the bidder needs 80% of the votes and value. In some cases, hedge funds acquired 25% of the share capital to block integration. More common however would be a strategic block of 5% that prevents the bidder from squeezing-out minority shareholders. Early 2007, in *Techem*, for the first time hedge fund money was rumored to have accumulated even a simple majority (+50% plus one vote) which ultimately prevented a bid from closing: A paradigm change in that hedge funds had not previously openly and successfully blocked a transaction pursued by another financial sponsor.

Often paying greenmail to the hold-outs is by far cheaper than fighting. The downside is that markets will know and remember.

## 3. Excess Cash

In 2006, DAX companies distributed an average 37% of balance sheet profits to shareholders. In comparison many foreign investors would expect 50%; in their view the difference belongs to

them. Yet the issue of excess cash is less about an expected distribution level and rather about a sensible employment of capital. By definition, a company has excess cash if there is cash (or cash equivalents) but no convincing plan to employ it (capex spending plan, R&D, acquisitions).

Most recently in *Cewe Color*, hedge funds had sensed excess cash in what then appeared to be a vastly overcapitalized balance sheet and demanded distribution to shareholders. From a corporate finance perspective, if there is unneeded capital, it should be returned to shareholders. But rallying hedge funds failed to convince a sufficient number of shareholders that the company was in fact accumulating cash that could not be employed to foster future profitable growth. Why so? If from a particular shareholder's perspective the risk/return equation is unsatisfactory, but by objective standards there is no unneeded cash, such shareholder should take out his or her money by selling the stock. *Cewe Color's* balance sheet might not have been ideally structured, but this would rather appear to be a question of management's business judgment. While management can be expected to optimize the balance sheet to maximize shareholder value over time, management cannot be expected to leverage the balance sheet for the sole purpose of generating excess cash to be given away to drive-by investors.

That is also why the argument is cutting both ways: If the company was accumulating unneeded money, then a responsible board should have returned the excess cash to shareholders (*Graham* paradox of "large working capital in mediocre companies"). But if the company did not, then the funds's investment thesis was fundamentally

flawed ("large capital under management in mediocre hedge funds" paradox) - in which case a responsible fund manager could be expected to allocate assets to a more promising investment opportunity and failing that to return capital to investors.

Many investors apparently felt that in *CeWe Color* both management and hedge funds failed to back up their respective propositions that there was not or that their was unneeded cash. For the former reason, many value investors sold the stock and for the latter reason, too few hedge funds invested alongside *M2* to win against a defense alliance of family shareholders, management, unions/employees, and local politics (*i.e.*, a state-owned bank).

#### 4. Removal of Management-Discount

The average German CEO is in office six and a half years but only two and a half if said to have failed. Since 1995, the number of involuntary changes on C-level is estimated to have increased by 300%. Unless management has a proven track record of creating value and consistently meeting return expectations, it is easy for activist shareholders to lobby against management to force through a change. And even then, it is easy to criticize management for lack of transparency, managerial hybrids, empire building, being caught in agency conflicts, or building up a war chest for allegedly value destructing acquisitions.

Most recent examples include *Deutsche Börse*. *Deutsche Börse* and *Euronext* were competing for the *London Stock Exchange*. Funds felt that although the transaction rationale was sound, *Deutsche Börse*, in a third attempt to combine with *LSE*, was about to vastly overpay. More importantly, as a *de facto* monopolist *Deutsche Börse* apparently

had the market power to command prices and to collect large sums of cash within a fairly limited period of time. Activist funds claimed that the premium offered by *Deutsche Börse* would have constituted a dissipation of shareholder money and that the CEO who insisted on the transaction needed to be replaced. The supervisory board chairman was backing the CEO. Since under corporate law a direct attack against the CEO was not possible, yet against the chairman, funds alleged that the supervisory board chairman needed to be replaced as well because of a failure of corporate controls. Institutions sold out to activist funds, and funds forced through a management change at *Deutsche Börse*. The bids fell apart and the *LSE* remained independent. Consolidation pressure subsequently led to a takeover of *Euronext* by the *New York Stock Exchange*. As could be anticipated, *LSE* stock fell, *Deutsche Börse* and *Euronext* stock soared. He who was long in *Deutsche Börse*, short in *LSE*, and long in *Euronext* generated unprecedented returns within a couple of weeks. *Deutsche Börse* was subsequently forced to pay out its war chest to shareholders. The case of investment legend *Warren Buffet* illustrates that actual qualification for a position is of minor relevance and perceived competence is decisive. Mr. *Buffet's* decision not to serve an additional term on the board of the Coca-Cola Company resulted in an immediate share price appreciation of more than 1.5 billion Euros, suggesting that he was perceived to have lost his Midas touch. Sub-standard performance will be even less tolerated. Attacking management is often the fastest and easiest route to success because people like to believe that incumbent management is

incompetent, earns way too much, did not deliver on past promises and won't in the near future etc; because it is almost impossible to prove the opposite even if allegations are unfounded; because human beings can stand public pressure and defamation only to a limited extent, may compromise on business items to protect their immediate family, or ultimately give in or be ousted by the board; because it is easier to split a board over an individual than over facts or opinion (in particular, if criminal prosecution is instigated); and technically, because a change in management is in principle achievable through means provided by corporate law whereas a direct change in strategy is not.

### C. The Danger of Momentum

#### 1. Critical Mass

Key event driven tactics are to accumulate an initial position by acquiring voting stock or the right to acquire voting stock (options, swaps); send “wake-up” or greenmail letters; attract public attention, by advertising the investment thesis within the investment community, the market place, and financial media; do road shows or run a public campaign; take corporate action; and engage in shareholder litigation.

The single biggest danger of all lies in the coincidence of two factors: The target company being vulnerable, actually or perceived, and the activist shareholder creating momentum that he will be unable to control or stop due to an increasing number of free-riders, such as other event-driven/opportunistic investment funds, arbitrageurs, short-sellers, minority shareholders associations, individual

shareholder activists, professional greenmailers, and journalists wishing to capitalize on the story for as long as possible a time.

Why is momentum so dangerous? In the midst of a market inefficiency, once detected, a special breed of market participants will emerge and act highly efficiently, exploiting (and thereby closing) the efficiency gap. Like water, money will find its way: Once enough financial investors are convinced that a certain behavior is rational, they will all behave in such manner without a need for co-ordination. Investors will act in parallel, each investor driven by pure self-interest, without the original aggressor having the possibility of stopping the others. Regulatory action will not stop momentum either, for parallel action is lawful and concerted action almost impossible to prove. And even if activist funds acted in concert: Concerted action is legal and legitimate; it is only that concerted action triggers certain regulatory consequences. One consequence is that concert parties who failed to comply with mandatory threshold reporting lose their voting rights until they make up for that omission; this could in theory help management win a stand-off at a general meeting. The second, most practical, consequence is that concert parties owe a mandatory offer for the company – which is the least desirable outcome from incumbent management's perspective.

Matter of fact, once a critical mass has been reached, the outcome is almost inevitable. Funds will win.

## 2. AGM

In an AGM context, critical mass is determined by AGM attendance rates. Many resolutions require only a simple majority of 50% plus one of all votes

present and cast. Taking the 2006 average DAX 30 attendance level of 49,88% as an example, a position of 24,94% plus one vote would convey a factual majority. Experience shows that 50% of the total share capital of a target company may change hands within weeks. But raising attendance levels as such is no solution to the problem: Not only are more shareholders needed to attend the meeting; what is more, shareholders must vote in favor of management (or at least abstain from voting). Best practice IR and communications can help to achieve this. While resolutions at general meetings need to be passed first, it is of equal importance that they will later be entered into the commercial register to become effective, quick, and that they will withstand legal challenges.

A shareholder's ability to bring about management change ultimately depends on three factors, namely shareholder base, attendance level at the general meeting, and likely voting behavior. Likely, not actual, voting behavior because management will almost always tend to avoid a public stand-off at a general meeting. Taking a resolution to dismiss a supervisory board member as an example, AGM momentum will therefore comprise of votes in favor and votes to abstain, known and assumed, and may even include votes against if not cast in open support of management, all in proportion to likely attendance.

Preparation for a general meeting may include a step-by-step analysis of all of the company's actions in preparation of, and during, the AGM; liaising with, or hiring of, trouble makers; involving private eyes to investigate everything of interest to the aggrieved shareholder. Based on publicly available information

alone, it appears, some funds prepare better than the company. Depending on sophistication of the fund, event-driven hedge funds must be expected to prepare themselves thoroughly and execute without compromise. Some funds are said to have deliberately lost millions only to preserve their track record of never, ever, going away from a situation.

Typically, an activist investor will engage in guerilla perception warfare, by advertising the investment thesis within the investment community to create further momentum and increase pressure on target management; by lobbying the market place; and by feeding the financial press to mobilize shareholder opinion. The activist may also run a public campaign prior to an AGM: Set up a dedicated website; comment on agenda items or announce his voting behavior prior to the AGM; bring in counter-motions or own motions; cause other shareholders to rally at the AGM; speak up at the AGM, ask questions and comment; work the press at the AGM; and challenge resolutions passed at the AGM in court.

On the subject of shareholder litigation, German listed companies are quite used to law suits filed by “predatory minority shareholders,” shareholders who challenge resolutions in court, sometimes on the basis of a single share. In-house legal departments and outside counsel know from experience that those law suits are later either dismissed without merits or settled, even though they create a huge nuisance and may sometimes pose a considerable threat. Often such shareholder behavior is abusive, frivolous or outright fraudulent. In a recent case, a minority shareholder instigated an action to void and set

aside an AGM resolution of capital increase and offered to the company to abandon his law suit against excessive consideration. The court dismissed the case and granted the company’s affirmative counter-action, expressly ruling that the plaintiff had caused damage unlawfully, willfully, and contrary to public policy and was liable for all damage the company may have suffered in the past or may be suffering in the future because of the delayed implementation of the capital increase (Frankfurt Regional Court, 3-5 O 177/07 of 2 October 2007, *Nanoinvests*).

Activist investors do not normally engage in frivolous litigation, but might try a case even on low prospects of winning. When confronted with a sophisticated event-driven hedge fund, companies should be aware of the fact that some funds will apply enormous resources to the task and do have a consistent track record of winning in court. Resolutions passed at an AGM past midnight are null and void – a company should not expect an activist investor to tolerate such a blatant mistake (Düsseldorf Regional Court, 36 O 99/06 of 16 May 2007, *DIS*). Companies should also bear in mind that only recently a court granted a court-appointed, minority shareholders’s “special representative” unlimited discovery in respect of all *HVB* premises, files, and communication – including board minutes, files of the in-house legal, tax and M&A department, and including communication with external advisors such as investment banks, legal or tax advisors and auditors – to assess whether or not *HVB* sold *Bank Austria Creditanstalt (BA-CA)* below value to parent company *Unicredit*, resulting in a pecuniary loss for *HVB* or *HVB* minority shareholders (Regional Court

Munich, 5HK O 12570/07 of 6 September 2007). On 31 January 2008, the court ruled that *HVB's* resolution to sell *BA-CA* was void (5 HK O 19782/06); a further decision regarding the subsequent squeeze-out resolution is expected for 21 February 2008.

#### D. Defense

If caught by surprise, the company may choose to pay “greenmail” (ransom) or to go to war. Both tactics need to be evaluated very carefully. In an early stage of the debate it is often possible to agree with an activist investor to implement certain changes within a reasonable period of time. When going to war, it is crucial that the target company’s advisors are on par with the adversary in terms of sophistication and commercial mindset.

Being prepared is obviously the better approach. In essence, the single most important objective is not to be or to appear vulnerable. Companies should therefore avoid exposure to typical event-driven situations. To be fair, this is not always possible. To add insult to injury, some defense measures constitute “events” in themselves and thus expose the company to risk. Implementation must therefore be balanced out and executed with great caution. This is best evidenced by share buy-backs: Selling shareholders will prefer management to buy back shares above value, remaining shareholders will prefer management to buy back shares below value. It might be tempting to buy back shares at inflated prices to further manage up the share price, but this might also prompt a shareholder revolt.

Defense strategies are by their very nature long-term-oriented, but may create protection in the mid-term.

Suitable defense strategies are to carry out communications audits (internal and external perception studies); to shape perception and investor sentiment; to initiate and maintain an intense shareholder dialogue; to revise the capital structure (share repurchase, dividend increase, stock split, etc); and to optimize the company’s portfolio (catch up with peer group in respect of performance, valuation/multiples, market cap, etc).

In doing this, ensuring supervisory board support is critical. Support is granted, not demanded and must be deserved. External directors who have been involved in the good times are more likely to back management during a crisis; beyond the obvious this is very much about supervisory board composition, boardroom dynamics, information flow, and accountability, and therefore at the very heart of a company’s approach to corporate governance: A supervisory body that focuses on structures, process, and quantity of corporate control mechanisms versus one that focuses on content, quality of controls, and value-creation through supervision (“*the value a board adds to the corporation*,” as board consultant *Ram Charan* puts it). A board that has been rather detached for years is less likely to support management in a crisis than a board that is used to be actively involved in the company’s affairs. The former, “*ceremonial*,” board may cease to back management simply because it was never convinced of management’s strategy, only persuaded.

Anchor shareholders will often be represented in the supervisory board and may prove supportive of management – until the price is too tempting and they too sell out to hedge funds. Should, then, hedge funds be granted a supervisory board seat?

Companies must first accept the idea that there are no right or wrong shareholders, only shareholders whose objectives may be a fit or gradual misfit. Even though representation on the supervisory board in proportion to shareholding is not provided for under German corporate law, many supervisory boards reflect the actual ownership structure. In the case of an existing proportionate board, there is no reason to deny a large shareholder proportionate board representation but for two reasons: Either if the shareholder's investment horizon is without doubt so short that the demand for a supervisory board seat is frivolous or at least plainly unreasonable; or if such shareholder fails to present a candidate who is eligible under corporate law and who possesses the "*required knowledge, abilities and expert experience*" and is "*sufficiently independent*" under soft law, *i.e.*, the Corporate Governance Code. Whether or not a candidate will act sufficiently independently is hard to anticipate. Just as the shareholder will want "his" candidate to represent his interests, incumbent management will want the candidate not to interfere with theirs. Probing question is, can the candidate be expected to act in the best interest of the company, shareholders, and stakeholders, as required by law, under the conditions of a proportionate board, even though he or she is sent on the board to serve a particular shareholder's interest? Unless the answer is clearly in the negative, such candidate must be deemed acceptable.

Companies should know their shareholders which includes knowing their objectives, investment style, investment strategy, and investment thesis. Is a particular investor's style long-only, long/short, or short-only?

What is the size of position relative to the size of the fund? What are the investor's return on investment needs and wants? How, exactly, does the investor plan to create and extract value from the situation? Can the company help facilitate a convenient exit? What is he willing to do to succeed?

Accurate and complete reporting should be a given. Investor relations should communicate with all shareholders, even with the most aggressive activist funds, and maintain an intense and open dialogue on almost any topic a given shareholder would like to discuss – within the legal limits but without thought control. This is for two reasons: Firstly, interaction with a competent, hands-on investor who truly cares about the company's long-term prospects can indeed be fruitful and generate long-term value; it can even help management to overcome internal resistance against a sensible strategy change. Secondly, while it is unpleasant to be summoned to London or New York to be exposed to a poorly researched presentation that alleges that management is living in an ivory tower, is bound by agency conflicts, did not deliver, and should commit to significant changes, ignorance of the situation will not cause the activist to go away. Management must instead practice the art and craft of active and sympathetic listening; thoroughly and diligently review any proposal or demands an activist investor presents; and thoughtfully and disinterestedly weigh the pros and cons, always assessing the level of support within the shareholder base.

Typical shareholder demands are related to strategy (70%), corporate governance (40%) and employment of capital (30%). If a demand or proposal turns out to be reasonable, the

company should publicly announce its intention to implement a specific change within a specific, reasonable period of time. If a proposal turns out to be unreasonable, and sufficient shareholder support likely, management should not simply resort to its authority conveyed by its rank or the business judgment rules, but rather explain why exactly the demand is disadvantageous for the company and for the by far greater number of shareholders, and why it contradicts the company's already pursued strategy. Where available, management should solicit public third party support, such as supportive statements made by an anchor shareholder.

High cash positions will attract speculation. As regards excess cash, management must acknowledge that shareholders will have their own views on how it should be employed. In the presence of high cash positions it is of crucial importance to demonstrate that the accumulated cash position is meant to be reinvested in line with the company's overall strategy and risk profile. Capex spending could even be long-term and risky, as in the case of a pharmaceutical company funding R&D, if only there is a reasonable expectation that capex spending will result in a corresponding increase in value. In the case of mergers and acquisitions, management should carefully sound out shareholder sentiment and if at all possible solicit the views of key shareholders in advance. Once a proposed transaction is publicly contested, management should consider to submit the merger proposal to shareholders for them to decide – irrespective of whether or not shareholders must, technically, be consulted under the “*Holz Müller/Gelatine*” corporate law

doctrine (pursuant to which in exceptional cases management's actions are subject to an unwritten requirement for prior shareholder approval). In the event of a general meeting, management should avoid an either/or-decision between the proposed transaction and a return of capital, otherwise it might well lose its war chest to short-termist shareholders who do not view stock as a fraction of a going concern business but rather as a lottery ticket.

Shareholders are pursuing business interests through a corporate vehicle that is temporarily entrusted to senior management. For some shareholders management's mission is, in the words of *Roberto Goizeta*, “*to create value for shareholders over time.*” Others feel duty-bound to their own investors who have sent them on a mission to harness value from corporate events. For it is the shareholders who own the company, management should constantly seek a fit between the investment strategy of its shareholder base and the business model and strategy of the company. Once the “wrong” shareholders effectively own the company, it will be too late and shareholders will change the company's strategy. Key therefore is to attract and keep the “right” shareholders and to be unattractive for those whose objectives would be a clear mismatch.

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The author is a Managing Director with global communications consultancy Citigate Dewe Rogerson. He focuses his practice on public M&A and special situations. He is admitted to the Frankfurt bar, as well as to a regional stock exchange. Most recently he was involved in BASF/Engelhard, Linde/BOC, Schering/Merck/Bayer, Techem, and PrimaCom, as well as in various defense mandates. Previously as a lawyer he represented hedge funds, most notably in *Wella* and *Deutsche Börse*. ©AE 02/08