SHAREHOLDER EMPOWERMENT
Shareholder Empowerment

A New Era in Corporate Governance

Edited by
Maria Goranova and Lori Verstegen Ryan
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The board-centric governance model in which shareholders have limited powers is under assault by shareholders. A new class of activist shareholders is leading the charge. As a cofounder of Relational Investors LLC in 1996, I have been at the forefront of these changes. Relational Investors is one of the first and largest activist investors and manages more than $6 billion. Since 1996, Relational Investors has engaged over 135 companies and gained minority board representation on 18 public company boards, including Home Depot, Hewlett-Packard, Mattel, Waste Management, Intuit, and ConAgra. The changes sought by Relational Investors in the areas of capital allocation, compensation, governance, and business strategy and operations have significantly improved the long-term value for shareholders of these engaged companies.

Despite our extensive boardroom experience and impeccable reputations, it is extremely rare for a portfolio company to invite my partner, Ralph Whitworth, or me to join the board. The threat of a proxy contest for minority board representation (typically, only one seat) is necessary to gain the leverage needed to obtain a board seat. Public company boards not only lack diversity, but also seldom include a significant shareholder.

During the “Corporate Raider” decade of the 1980s, most contests involved a change of control—a leverage buyout, strategic acquisition or merger, or contest for control of the board. Public companies were “put in play” by a so-called corporate raider hoping for a strategic buyer to acquire the company as a white knight. The tactics were crude and led to abuse. Defenses such as staggered boards and poison pills were developed to counter the “threat.”

In 1992, the Securities and Exchange Commission adopted the “Short Slate” rule, effectively permitting shareholders to run for minority board representation. The “Short Slate” rule opened the door to today’s activist shareholders by neutering the effectiveness of firms’ well developed defenses. Instead of trying to force a change-of-control transaction, the activist now could merely seek one or two board seats.

Not surprisingly, the prospect of losing a board seat to an investor with an agenda actually becomes a referendum on the agenda itself. In some cases, the agenda is as simple as improving boardroom dynamics by electing a significant shareholder to the board. Institutional shareholders almost universally support the addition of a significant shareholder’s well qualified representative to the board of an underperforming public company. Once in the boardroom, the activist still needs to galvanize support among the other board members to
effect any change. In my experience, board members are well intentioned, but lack the resources necessary to evaluate strategic alternatives properly. Therefore, the board places too much reliance upon management, which is often misguided through poorly designed compensation schemes. Too often, boards operate without multiyear business plans that are directly tied to long-term compensation. The result is that managements become overly focused on the short-term annual results that primarily drive their compensation.

Those arguing against shareholder empowerment believe that shareholders, especially activist shareholders, are too focused on the short-term, and that companies, in their reaction to these vocal shareholders, are destroying long-term shareholder value. This argument fails, in that the supposed threat is merely the addition of a single significant shareholder representative to the board—not a threat worthy of sacrificing long-term shareholder value. Instead, it is management, in their effort to thwart any threat to their position and to continue to control the flow of information into the boardroom, that generates the response.

The explanation for the immediate positive reaction by the market to the involvement of an activist is not short-term manipulation, but that long-term shareholder value is likely to be enhanced soon through the adoption of a superior business strategy. While on average the companies engaged by Relational Investors materially underperformed the market during the five years prior to our involvement, they not only outperformed during the period of our engagement (generally, three years), but they continued to outperform for the one, three and five year periods following our engagement and exit. This continued outperformance explains our ability to exit the stock by selling to other so-called long-term shareholders.

Finally, I firmly believe that the stock market remains focused on and effectively values the long-term future value of companies traded in the public markets.

Whatever your view, shareholders have been effective in improving overall corporate governance and reining in certain abuses in compensation. More forceful shareholder empowerment is now causing individual board members to become directly involved in reaching out to shareholders to explain and receive feedback on their long-term business plans. The end result will be more involved and better functioning boards and improved alignment with shareholders.

I applaud Lori Ryan and Maria Goranova for their efforts in furthering the discussion of shareholder empowerment. Lori has pioneered the study of responsible corporate governance through her work at San Diego State University’s Corporate Governance Institute while educating our future business leaders.

**DAVID H. BATCHELDER**
Cofounder of Relational Investors LLC
San Diego, California
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<td>AFL-CIO</td>
<td>American Federation of Labor and Congress of Industrial Organizations</td>
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<td>AOL</td>
<td>America Online</td>
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<td>BofA</td>
<td>Bank of America</td>
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<tr>
<td>CalPERS</td>
<td>California Public Employees’ Retirement System</td>
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<td>CEE</td>
<td>Central and Eastern Europe</td>
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<td>CEMs</td>
<td>control-enhancing mechanisms</td>
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<tr>
<td>CEO</td>
<td>chief executive officer</td>
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<td>CFO</td>
<td>chief financial officer</td>
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<tr>
<td>CII</td>
<td>Council for Institutional Investors</td>
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<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>DOW</td>
<td>Dow Chemical Company</td>
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<td>DTC</td>
<td>Depository Trust Company</td>
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<td>EEOC</td>
<td>Equal Employment Opportunity Act of 1972</td>
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<td>ESBs</td>
<td>effective staggered boards</td>
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<td>ESMA</td>
<td>European Securities and Markets Authority</td>
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<td>FBI</td>
<td>Federal Bureau of Investigation</td>
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<td>FTSE</td>
<td>Financial Times Stock Exchange</td>
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<td>GRI</td>
<td>Global Reporting Initiative</td>
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<td>HTV</td>
<td>hard-to-value</td>
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<td>ICCR</td>
<td>Interfaith Center on Corporate Responsibility</td>
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<td>IIRC</td>
<td>International Integrated Reporting Council</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPO</td>
<td>initial public offering</td>
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<td>IR</td>
<td>investor relations</td>
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<td>IRO</td>
<td>investor relations officer</td>
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<td>ISS</td>
<td>Institutional Shareholder Service</td>
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<td>LCD</td>
<td>liquid-crystal display</td>
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<td>M&amp;A</td>
<td>mergers and acquisitions</td>
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<tr>
<td>NASDAQ</td>
<td>National Association of Securities Dealers Automated Quotations</td>
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<tr>
<td>NGO</td>
<td>nongovernmental organization</td>
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<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Co-Operation and Development</td>
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<td>PA</td>
<td>principal-agent</td>
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<td>R&amp;D</td>
<td>research and development</td>
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RI    responsible investment
ROA   return on assets
ROs   religious organizations
S&P   Standard and Poor's
SDX   Shareholder-Director Exchange
SEC   Securities and Exchange Commission
SND   shareholder nominated director
SOE   state-owned enterprise
SOX   Sarbanes-Oxley Act, Public Company Accounting Reform and
      Investor Protection Act of 2002
SRI   socially responsible investing
UNPRI United Nations Principles for Responsible Investment
USSF  Forum for Sustainable and Responsible Investment
VC    venture capital
VC    venture capitalist
VIF   voting instruction form