

Shareholder Activism: Greenmail to Governance

by Sundar Sankaran*

Greenmail was once very common in the United States. The greenmailer would buy significant stake in a company, and threaten to make a public offer for the rest of the company. If the company wished to ward off the threat, it would have to buy the significant stake from the greenmailer at an inflated price. So abominable was this blackmailing by the stakeholder to green himself at the cost of the company or its controlling shareholders, that the US imposed a special “greenmail tax” on the gains made through this route!

In India we had a *desi* version of greenmail. People with **insignificant** stake would threaten to use their freedom of speech at Annual General Meetings of reputed companies to broach non-existent issues of integrity or inefficiency. Companies did not want the person to sow the seeds of doubt in the minds of other shareholders. The escape route available to companies was to offer a little perk – an out-of-turn allotment or admission, personal meeting with Chairman, job for a family member etc.

Shareholder activism has come a long way from greenmail to *governance*, an initiative kicked off in the United Kingdom in the early 1990s by the Cadbury Committee. This committee examined the financial aspects of corporate governance to understand the system by which companies are run.

Business School IMD has given an over-arching perspective on *corporate governance* as “a question of performance accountability...the various legal frameworks for corporate activity to ultimately deal with the questions: *to whom* and *for what* corporations shall be held *accountable*”.

There is now wide acceptance that corporations need to be run for the **Corporations need to be run for the balanced benefit of all stakeholders** viz. *balanced benefit of all stakeholders* viz. controlling shareholders, minority shareholders, debt providers, customers, employees and society at large. A host of accounting irregularities hit American corporations in the 2000s. This sparked a fresh bout of interest in corporate governance.

* Sundar Sankaran is Founder-Director of Advantage-India Consulting Private Limited. He is also author of “Indian Mutual Funds Handbook” [Vision Books: 2003, 2004 (reprint)]. Sundar can be reached at sundar@advantage-india.com

Growing institutional holding in companies has created a body of shareholders who have the *intelligence* to keep a watch on companies. Should application of this intelligence be made compulsory? The United States, which has been the fountainhead of many of the recent accounting irregularities, is the thought-leader for mandatory activism. It has enshrined responsibilities in Employment Retirement Income Security Act 1974 (ERISA), and supplemented it with guidance issued by the Department of Labor. Europe and Australia are not so sure about imposing activism. In Britain, the Institutional Shareholders Committee, which represents the country's pension funds, insurers, fund managers and unit trusts (mutual funds), has announced a new activist code.

India is yet to take a view, perhaps because the local fund management industry has not reached that scale. Emerging markets guru Mark Mobius recently said that Templeton Mutual Fund actively makes use of its right to vote to push companies to adopt practices that treat minority shareholders fairly. “We do have a mandate: if we have to, we do go out and vote on board meetings. Going forward, corporate governance will play an increasing role. And the reason why we say that is because we feel that corporate governance is going to have an impact on value”¹.

India is yet to take a view, perhaps because the local fund management industry has not reached that scale.

Triggers for Corporate Governance

Let us examine some situations that test the nerve of corporate governance.

- 1) *Executive pay* – Owner-managers reward themselves and their cronies with generous parachutes and golden handcuffs. This has been the most important concern among stakeholders in American corporations.
- 2) *Conflict of interest* – During the fight over the merger of Hewlett-Packard (HP) with Compaq, Carly Fiorina, HP's chief executive reportedly told Deutsche Asset Management, part of Deutsche Bank, that a vote for the merger was “of great importance to our ongoing relationship”. The fund manager voted in favour, days after Deutsche Bank had signed a \$4 billion revolving credit facility for HP to pay for the merger. Court ruled in favour of HP – doubts remain in the minds of stakeholders.

A situation could well develop, where a pension fund that has invested in a company may also be managing the investment portfolio of the investee company or its employees. Will the pension fund manager be prepared to perform an activist role, at the risk of losing the fees from the other business?

- 3) *Transactions with group companies* – One of the unintended consequences of the Monopolies and Restrictive Trade Practices Act in India was the complex web of holding companies that promoters created. Although investment regulations

¹ “MFs flex their muscles, raise decibel level on company boards”, Economic Times, November 20, 2004

have been liberalized, the group company route to expansion / diversification remains. The most visible example today is the investment of tens of thousands of crores by Reliance Industries in Reliance Infocomm, which is a company whose shareholding structure remains opaque.

- 4) *Poison Pill* – These are measures that make it unpalatable for a company to be swallowed (taken over). At what stage do measures to ensure management stability become barriers to throwing out inefficient management? There can be no ready answer.
- 5) *Stock issues* – Singapore engineering company, NatSteel offered to double its dividend payout if, and only if, minority investors approve a rule that makes it easier to issue convertible bonds. Is dividend a distribution of profits, or a carrot for *quid pro quo* arrangements with investors?
Is dividend a distribution of profits, or a carrot for quid pro quo arrangements with investors?
- 6) *Accounting irregularities* – The now defunct Global Trust Bank is the most current example in India. The bank's auditors face inconvenient questions, while the promoters await criminal cases. What were the independent directors doing? Did the regulators act in time?
- 7) *Ownership issues* – The tussle among the Ambani brothers over Reliance highlights the criticality of ownership issues, and their impact on employees. Whatever may be the level of "professional management", protracted intra-family fights pull down company performance over the medium term.

Tools for activism

In the normal course, directors are responsible for protecting the interest of shareholders. Independent directors have a greater role in inspiring comfort at the decision making level. Accounting comfort is provided by the auditors. In the event of discomfort, issues can be escalated through:

- 1) *Direct discussions with the company* – This facility is typically available for large investors. They are in a position to discuss issues across the table with senior management to resolve differences.
In the United States, PricewaterhouseCoopers conducted an interesting survey of 120 companies that have institutional investors. The finding: Although institutional investors hold an average of 61 percent of shares, 60 percent of the CFOs and managing directors polled say these institutions either have no impact on corporate direction or are neutral.
- 2) *Proxy Voting* – If the issues cannot be resolved through discussions, then meetings become a forum for investors to make their preferences clear. In Britain, little more than half of the shares in the biggest 350 companies are voted. Votes against management are rare. Voting levels are higher in America, at about 80%². In Australia, a study³ indicated that of all shares held by the sample on

² "Will the owners please stand up?", The Economist, October 31, 2002

behalf of investors, 96% are subject either to high levels of voting or frequent direct contact [with companies] and, often, to both these forms of shareholder activism.

To put these numbers in context, Harvey Pitt, former chairman of the Securities and Exchange Commission once said "I grew up in an era when shareholder proposals barely got a 2 percent vote."

In India, the voting right exercisable in meetings remains the most widely known and least used power. The system of postal ballots is in its infancy. Electronic voting is not permitted.

In India, the voting right exercisable in meetings remains the most widely known and least used power.

- 3) *Requisition for Meetings* – In the normal course, directors convene the meetings of the company. Under the Companies Act, 1956, member/s representing at least one-tenth of the voting power in the company can requisition a meeting. If the company does not proceed to call the meeting, then the requisitionists can call a meeting at the expense of the company.

This right to force meetings, or propose resolutions not backed by management, is being increasingly used abroad. According to the Investor Responsibility Research Center, in 2003 shareholders filed some 1,126 proposals with corporations. In 2002, that number was closer to 800.

- 4) *Company Law Board* – Under Section 397 and section 398 of the Companies Act, 1956 members can complain to the Company Law Board if the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members or if there is a material adverse change in the management or control of the company. The application can be made by 100 members or one-tenth of the total number of members in the company, whichever is less, or member/s holding not less than one-tenth of the issued share capital of the company.
- 5) *Court* – In extreme cases, aggrieved investors would have to approach the court. Recently, a dispute between two sections of BPL's Nambiar family was taken up in court.

Ground realities

- 1) *Inactive individual investors* – Most investors have a lackadaisical attitude towards enforcing their rights. Large investors who have more at stake are generally more vigilant.
- 2) *Regulatory systems and Judicial delivery mechanisms* – In many ways, India suffers from a problem of too many *regulations* and too little *regulation*. Judicial proceedings tend to extend over several years – at times decades. In such a scenario, the need for robust corporate governance mechanisms is even more.

³ "Shareholder Activism among fund managers: Policy & Practice", Eureka Strategic Research on behalf of Investment & Financial Services Association Ltd

- 3) *Too few long term companies of size* - Advantage-India's research based on the Capital Market database indicates that there are only 557 listed companies which are more than 30 years old, of which merely 213 have survived 50 years. Many of these companies have extremely small capital base and / or hardly traded in the market. With such a narrow spread on offer, it is difficult for investors to choose not to invest in a company they are not comfortable with. When such companies are part of the index, then passive funds have to necessarily invest in them. It therefore is important for institutional investors to be activist in their approach to governance issues in companies they invest in, rather than take the easy route of withholding investment in these companies.
- 4) *Presence across the financial services space* – Several significant participants in the financial services space have a presence across different businesses, such as banking, insurance, mutual fund, broking and investment banking. Pension funds will be another business that they will get into. The scope for conflict of interest situations increases with such spread of business activities, poor demarcations between them and frequent employee mobility. The HP – Deutsche example is a case in point.

The scope for conflict of interest situations increases with such spread of business activities, poor demarcations between them and frequent employee mobility.
- 5) *Voting in Global Depository Receipts (GDR)* – GDRs are issued against the backing of shares registered in the name of the custodian. Investors in the GDR often get into an arrangement where they will vote with the management in meetings. Such structures are not conducive to activism by this growing body of investors.

Elusive consensus on debatable issues

- 1) *Voluntary v/s mandatory activism* – Can responsibility for activism be imposed? Mandating activism could lead to a “tick box” approach to governance, which will not serve any purpose. It would be better to let the valuation concerns of institutional investors drive their activism – and catalyse an environment where the market punishes with poor valuation, companies that have unsatisfactory record of governance. Further, investors should be encouraged to prefer funds that are proactive towards governance in the companies they invest in.

It would be better to let the valuation concerns of institutional investors drive their activism
- 2) *Voting power in democracy v/s voting power in companies* – Despite the education drive to get people to exercise their franchise in a democracy, several eligible people do not vote in elections. The duty to exercise the franchise is even more in companies, because voting power in companies is limited by its share capital – unlike politics, where any one who is a major can vote.

- 3) *Active v/s passive investment philosophy* – It is tempting to presume that a passive fund manager (index funds) does not need to be activist in approach to governance. But the reverse is true. An active fund manager has an option of selling the shares in companies she is not comfortable with. A passive fund manager does not have this option. **A passive fund manager has a greater need to be activist**
She has to invest in all companies representing the index, irrespective of how poor the governance record of any company is. Therefore, a passive fund manager has a greater need to be activist and protect the value of the investment.
- 4) *Who bears the cost and who benefits* - The investor who is activist bears the cost and expenses of the activism. However, all investors will benefit if better governance prevails. Such asymmetric pattern of costs and benefits makes it inequitable to mandate the responsibility of activism on a few investors.
- 5) *Micro management* – The challenge is to be activist, without getting into micro management of companies. Activists will have to identify the few large issues that affect the basic direction and valuation of companies. This is absolutely essential to maintain a harmonious relationship between the management on the one hand, and directors and owners on the other.
- 6) *Insider trading* – During direct discussions with the company, several unpublished information could become available. The activist will have to enter into an agreement that in the course of discussions, the company will not disclose anything that will make the investor an “insider” under the insider trading regulations. This is essential to ensure that activism does not lead to loss of the freedom to trade in the shares of the company. **It is essential to ensure that activism does not lead to loss of the freedom to trade**
- 7) *Focus on society* – Cash outflows on social projects tend to be viewed as expenditure, rather than investment. Hence, it becomes difficult to justify them financially. Yet companies need to balance social interest. Dow Chemicals continues to carry the stigma of Union Carbide’s Bhopal gas tragedy.

Ideal Institutional role

The following could be considered as beacons for institutional investors – in particular those that manage assets of pension funds, mutual funds, insurance and other pooled investment vehicles.

- 1) Set a clear policy on the approach to activism, and make this known to clients on whose behalf they invest.
- 2) Take a call on the investee company’s governance systems viz. auditors, board composition, professionalisation in management etc. **Weaker the normal governance mechanisms, greater would be the need for activism.**

- 3) Seek to resolve issues through discussions with company management before taking issues to the public, either through the media or in general meetings. In extreme cases, the issues could be taken to the public as a pressure tactic.
- 4) Make complete disclosure of the meetings they attended, how they voted and reason for the same.
- 5) In the event that they plan to oppose any resolution, or even abstain from the voting, it would be a good practice to inform the company in advance. This would leave the door open for discussions pre-meeting; and help highlight the issues to other investors. As part of this process, proposed resolutions can be modified or dropped at the same meeting.

For instance, Calpers said it would withhold its vote for Warren Buffet, the billionaire investor and five other directors because they are members of the audit committee that authorized the auditor to perform non-audit services.

Structural reform

Structurally, the following measures would be useful.

- 1) Given the asymmetric behaviour of costs and benefits of activism, some group initiatives are necessary. For example, SEBI or some other independent agency can manage a corpus created out of capital market related pockets of funds, such as unpaid dividends that have lapsed, penalties for lapses etc.

Given the asymmetric behaviour of costs and benefits of activism, some group initiatives are necessary.

This could be used for educating investors or for research on governance related issues.

New York State Comptroller Alan Hevesi has proposed a National Coalition of Corporate Reform (NCCR), which would pursue its efforts through lobbying, litigation, proxy voting, and intervention in the regulatory process. NCCR will unite institutional and individual investors, labor leaders, corporate CEOs, elected officials and community leaders in support of a program of corporate governance reforms, regulation and legislation.

- 2) Given the insider trading fears of becoming activist and the specialization needs, outsourced proxy services providers have a role. They can research companies, prepare white papers on debatable issues etc. The cost of these could pass through the funds to investors in these funds.
- 3) Electronic voting would make it easier for investors to exercise their franchise. In an age where so many monetary transactions are done electronically, there can be no excuse for barring electronic voting on resolutions.
- 4) In the current system in companies, each director is elected by separate resolutions. Therefore, a shareholder who controls 51% stake is in a position to determine the entire board. Proportionate representation on board is an alternative. For example, every shareholding of 10% could entitle the investors to one seat on the board. This would ensure that composition of the board reflects the ownership structure better.

The corporation, as an instrument of commercial activity in an era of globalization, specialization and outsourcing will need to fulfill the expectations of an increasing number and variety of stakeholders. Stakeholders whose expectations are not met are bound to get activist. Even dormant volcanoes can erupt. Managing expectations and activism will be key requirements of organization leaders in future.