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Shareholder Activism and Adding Value in the United Kingdom

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“American history promotes the idea of solving problems while British history suggests problems are to be managed. Americans are therefore given to reinventing the wheel, whereas the British believe they invented the wheel in the first place.”[i]

“We had a discussion where we used the expression ‘to be the best and most successful company in the financial services industry.’ That was our vision… We started by comparing ourselves with British financial services companies, but the board wouldn’t have it…. So we resorted to the most admired American companies… Studying the Americans confirmed our impression that if you were the best at creating value for shareholders, you were also the best at attracting capital, satisfying customers, and looking after your people..” (emphasis added)[ii]

Investment capital is available in world markets at lowest cost to enterprises with the most transparent accounting and the most effective system of governance. Low cost of capital is critical to competitiveness. It is this imperative that drives each country and each company to assure the existence and functioning of a system of management accountability. This is not a question of formulaic (box ticking) nicety or ideological purity. It is the challenge of creating substantive accountability so that the interests of management and international investors can be seen to be precisely aligned. The board of directors is the corporate organ through which accountability must be exercised. In many respects we have assigned unrealistic responsibilities to the board. Rather than denying or working around this reality, we can overcome it through the involvement of informed activist shareholders.

The prospects for shareholder activism in the UK are uniquely favorable.[iii] The climate is far more hospitable in the UK than in the US. Because the law is not supportive, American “activists” must use confrontation and public relations to embarrass boards and managements into considering remedial action.[iv] In the UK, the shareholders are given full power by statute and there is public acceptance that owners be accorded ultimate right of decision. Ten percent of the shareholders can call an Extraordinary General Meeting (“EGM”); a majority of the quorum present at any meeting can discharge one or all of the directors; the Take Over Panel protects owners’ ultimate rights to evaluate tender offers. All of this is in contrast to the situation in the United States.[v] Beyond this, ownership is more concentrated in the UK – among the twenty largest institutional investors, no more than ten usually own over fifty percent of the stock of most traded companies.[vi] There is no question but that UK institutions have the legal authority, the power and societal approval to compel change.

LENS has been very much involved over the last dozen years as an “activist investor” in many of the great companies of America - American Express, Westinghouse, Eastman Kodak, Sears, Stone & Webster, Tenneco, Corning and Waste Management among them. At first with the investment of our own money and latterly with over one hundred million dollars of clients’ funds, we have - using the name LENS to connote our mode of focusing on underperforming companies - deliberately involved ourselves in situations where change appears necessary and value enhancement likely. LENS has just completed its sixth year as a special purpose partnership dedicated to proving that a company having effectively informed and involved owners is worth more than one without. We have outperformed the standard indices by over two hundred basis

points during that entire period. Annual Reports and full details about LENS are available on the Internet.

Activism pays. The best investors do it. Warren Buffett epitomizes the kind of monitoring shareholder whose involvement enhances the value of the whole enterprise. He personally salvaged the rogue Salomon Brothers from the bankrupting implications of its illegal activities. Buffett has devised a satisfactory structure by which he can be compensated for his efforts. Oftentimes – Champion Paper, Salomon Brothers, USAir – he will negotiate participation with management through a special class of equity security. These convertible preferred stocks assure Buffett both of downside protection and income as well as upside gain. He has a better deal than ordinary shareholders, but they have a better deal than they had absent Buffett's involvement. ("A rising tide lifts all the boats.") The market makes a calculation – the dilution caused by Buffett's preferred position discounted by the rise occasioned by his involvement - pre and post Buffett common stock prices. Unhappily, one cannot create a world system based on the availability of an infinite supply of Warren Buffetts, but his experience corroborates the worth of an effective monitoring shareholder.

In both the United States and the United Kingdom, we accept a number of unreconciled contradictions in our discussions of appropriate board functioning.[vii] The pivot of corporate governance is the non-executive ("independent") members of the board. The preponderance of American public company boards are comprised of independent directors with only one or two full time executives. I must make clear at the outset that while I personally have served on a dozen U.S. public company boards, I have no experience of being one of a minority of Non Executive Directors ("NEDs"), which would have been my fate had I comparable experience with UK companies. I cannot, personally, conceive of the dynamics of a board comprised of a majority of fellow members who are subordinate to the CEO[viii] performing its statutory duty of monitoring and overseeing management.[ix]

We continue to encourage an anomalous status for NEDs both in this country and in the U.S. When intelligent, honest professionals repeatedly use legal terms in a manner contrary to their commonly accepted usage, we are entitled to ask why. When the corporation laws of 50 states and many countries, including the UK, recite that directors are ***nominated***; the stockholders ***elect*** directors; that shareholders ***vote*** for their choice of nominees; that proxies are ***solicited*** for the election of directors, we are given an impression contrary to the actual practice. Law and lore have inveterately recited that the shareholders elect the directors, who in turn owe duties of care and loyalty. The board of directors is supposed and assumed to hold power granted to it by the owner shareholders. Excellent arguments can be made why boards of directors should be self-perpetuating. The need for collegiality in a managing board is one compelling reason. Why is there, then, reluctance to "call a spade a spade". That members are in fact appointed by the CEO and incumbents tends to dilute the board's "legitimacy" generally, but most specifically in determining the CEO's pay. The appearance of senior directors paying themselves creates needless friction for the corporate system. The fact that the power is self-perpetuating and not derived in any meaningful way from the shareholders may explain why the cosmetic vocabulary of "election", "nomination", "independent" and "vote" is retained. More than cosmetics is needed.

Boards not only do not perform the functions notionally required of them, they are structurally incapable of doing so. Both in the United States and in the United Kingdom we have come to discuss corporate governance with words and concepts that are borrowed from the vocabulary of our democratic political systems, but which obscure accurate analysis of the problems and opportunities. Why do we put up with it? It seems to work well enough. Nobody has devised a system that gives promise of working better. None of the parties who are adversely effected by this board dysfunction seem to care enough to demand change.

Boards may be deemed to have earned a measure of public trust with their record of sensitivity to the several corporate constituencies. There may be reluctance deriving from stakeholder concerns – expressed or implied – to encourage a transfer of perspective from

boards to shareholders. Hopefully, this will recede as “best practice” indicates otherwise. The McKinsey interview with Sir Brian Pitman, Chairman of Lloyds TSB, a portion of which is one of the headnotes for this paper, suggests that the focus on shareholder interests is the best way of assuring the prosperity of employees, suppliers, customers and other constituents.

The function of activist shareholders essentially is concerned with enabling and empowering the NEDs. Shareholders with a physical presence provide a tangible person for whom the director is working. This clear responsibility is necessary in light of the tolerated ambiguities in board accountability endemic to a self-perpetuating system. Activist shareholders, at their optimum, comprise an energy which informs and legitimates the non-executive directors in performance of their duties. Until the recent emergence of shareholder activism, non-executive directors existed in a kind of theoretical void – the scope of their responsibilities was legally clear enough but there was usually no participating institution or individual to whom they could actually relate. It is difficult to be a NED. There are times when one must confront, there are times when one must ask questions of individuals who are responsible for one’s presence on the board in full knowledge that the benefactor would prefer they not be raised. While there are individuals capable of such “integrity”, it is asking too much of most of us to function in abstract perfection. The activist shareholder anthropomorphizes the idealized NED. Ownership is the legitimating energy for the exercise of management power.

LENS’ experience with Stone & Webster in the United States, about which I have written in Chapter Eight of The Emperor’s Nightingale, was a process of ownership informing board members of their concerns, of the change of some board members, the reeducation of others and the nomination of new ones. Change was effected as the board, individually and collectively, became familiar with and persuaded of the merits of shareholder concern. The result is the emergence of a dynamically changed and successful venture.

Lens is indeed fortunate to have Hermes for a partner in the UK. There is no potential partner anywhere in the Anglophone world with Hermes’ dual characteristics of institutional stability and independence.[x] Hermes has essentially two customers, its own parent the British Telephone Pension System and the British Post Office Pension Fund. It can consider the needs for activist involvement without looking over its shoulder at any other commercial arrangements it might have with the focus company. It is clear that there are none.

Large private pension funds in the United States are understandably reluctant to put themselves in the position of appearing intrusive in the affairs of their customers and potential customers. **I can not cite a single example of shareholder activism or a shareholder resolution over the last fifteen years in the United States that was publicly identified with a private pension plan or one of its money managers**. It is clear that this dichotomy is not so clear in the United Kingdom. While Hermes has perhaps been conspicuously activist, there is some evidence that the major investment management firms will associate themselves with shareholder initiatives if they are not comfortable with taking the public lead. We need directly to ask the question – can there ever be an effective governance system so long as the largest class of institutional investor is permitted to stand on the sidelines. Unless the private pension system and their delegate money managers feel free, no – feel obligated, in their duty to beneficiaries, there will only be the shadow of an ownership based governance system.

It is increasingly clear in the United States that the world wide “market place”[xi] and shareholder value maximization are becoming the ultimate drivers of corporate decision. In the United Kingdom, the question is often raised whether other corporate constituencies – stakeholders – have interests of competing importance which should be taken into account and what corporate body should ultimately decide – the board of directors, for example – how to reconcile any conflict. The controlling shareholders in both countries are “trustees” and their management is subject to judicial review. In America, it is felt that “fiduciary capitalism” requires a spacious and long term of value maximization. In order to make this point emphatic, some scholars, notably Peter Drucker, use the terminology – value optimization.

McKinsey has suggested the concept of a “virtuous cycle” of value creation through focus on shareholder values**.** “Shareholder value is still a controversial topic in Europe, but we believe that embracing it is an essential ingredient of any plan for European economic reform. There is overwhelming evidence to support the view that shareholder value should be the explicit goal of all corporations. A shareholder mindset benefits not only the shareholders themselves, but society at large, setting in motion the virtuous cycle **of value creation, job creation and wealth creation.”**[xii] The question is very much alive in the United Kingdom as to whether any shareholders – fiduciary or otherwise – ought be entrusted with plenary authority to determine the “corporate good”. Ultimately the question can only be answered satisfactorily if the new institutional owner proves capable of taking a holistic perspective and considering business interests within the long term framework of a continuing free society.

When I refer to shareholders or “New Owners”, I take the local authority and private pension funds to be an appropriate proxy for the whole class of institutional owners.[xiii] The New Owners are ---

Universal in the sense of owning all public companies in all industries;

Long term in holding period (indeed, the pattern of indexation suggests virtually permanent ownership);

Global in outlook, with increasingly similar expectations for financial performance and reporting in all countries;

Humane in the sense that their beneficial owners comprise a substantial portion of the population and have the explicit human interest in a clean, safe and civil society, as well as adequate retirement income; and

Legal. They are not flesh and blood humans with the “thousand natural shocks that flesh is heir to”. They are constructs of law with the scope of their responsibility being subject to periodic definition by the legitimate law maker.

Much has been written about the difficulties that the institutional investors face of the “free rider” problem, of problems of fiduciary prudence and risk/reward, of conflicting interests in other relationships with portfolio companies, of the disinclination of the “New Owners” to expose themselves to the risks of activism, and, not least, of the utter lack of qualification that the current “New Owners” have for the challenge of effective shareholder involvement. We should no longer ask whether the institutional shareholders want the responsibility of ownership, nor even whether with their present staffing and configuration they are suitable to exercise it. Our society can no longer afford corporate owners who do not organize themselves to be responsible with the same tenacity and ingenuity they use to assert their prerogatives. Ownership implies responsibility. The challenge is how to make involvement attractive for the new owners.

There is no longer a large difference between the standards for governance as perceived by those primarily concerned with the legitimacy of corporate power and by those focused on competitive performance. This convergence expands governance concerns from the economic to the political sphere, from the corporate constituent to the citizen. *The Economist* explains the recent emergence of the United States as the most industrially competitive country in the world in terms of the population’s willingness to subordinate other concerns to economic ones: “No other rich country gives companies quite such a free hand to lay off workers and shirt resources from declining industries into growing ones. No other country refreshes itself in quite the same way by continuous waves of immigration… the special characteristic of American business is: ‘a willingness to reinvent itself and a willingness to see things disappear; an almost intuitive belief in Schumpeterianism. ‘People do not like it… but by and large they accept it. For as long as Americans are willing to put up with the mass lay-offs and accompanying social dislocation, these

are incomparable wealth-creating advantages.” The American model may not now be acceptable elsewhere, but we should be aware of the growing power of the Anglophone New Owners as the most involved and active shareholders of public companies all over the world.

Individual activists can make an adequate profit so as to justify their initiative. Why then can we not sit back, notice the ascending activist trend and confidently expect the market to do its magic. Stated another way - if the law is so plain and the evidence of value added through activism so indisputable, why have not disgruntled activists found relief in court? And why – in the United States - has the Department of Labor, the bedrock of fiduciary concern, not enforced the law? There are several reasons – most of them of the kind that appeal only to lawyers. First is the problem of proof. How can it be proven that the vote, or failure to vote, of a single shareholder *caused* a specific amount of damage. Even in those exceptional cases, where a particular vote was the difference between whether a motion carried or failed, how can it be proven that the fate of this one resolution was *the reason* that loss was incurred. And votes are the most tangible of shareholder prerogatives - the problems of proof and causality become more attenuated when talking of questions like replacing board members or changing strategy. If the courts are to be the institutional instrument for articulating and enforcing a *Law of Ownership*, the legal issues will have to be framed differently. In the UK, the question is frequently asked – is the answer in mandating votes by all fiduciaries or even by all shareholders? Sir Ronald Hampel really answered this question in the same way that it has been answered by the United States Federal government: “ … The right to vote is an important part of the asset represented by a share, and we think that an institution owes it to the client to make considered use of it… [I]t is salutary for the board to recognise that the support of the institutions is not automatic.”[xiv] Unhappily, the American “market” is polluted by mixed messages from government. On the one hand, ERISA[xv] provides in words as clear as language permits that trustees must consider “exclusively” the interests of beneficiaries; on the other hand the preponderance of ERISA fiduciaries have other commercial interests with portfolio companies and a pervasive concern not to act in a manner which would be viewed as threatening by CEOs in whose gifts lies the award of lucrative business.

There is no question but that the existing situation – which condones shareholder non-involvement – corrupts the marketplace. It would be well if the obstruction were removed.

Hermes and LENS – under the style Hermes/LENS Asset Management (“HLAM”) - are investment managers seeking to make money for our clients by exploiting an inefficiency that exists in the UK market place. There are many successful value investors. The informing theme of their style is that companies can be identified which have values that are not recognized for one reason or another by the market place. LENS has learned in the United States to apply yet another screen in its evaluation of “focus companies” so as to separate out those whose unrecognized values derive from problems appropriately soluble by shareholder involvements. We are learning the best ways to relate to company managements in the UK, which will in any case be different from the U.S. Such questions as excessive capitalization, promiscuous conglomeration and defective management are precisely those questions that law and tradition concede as being within the owners’ competency in both countries. It is our belief that institutional shareholder leadership will help to create a climate within which UK companies will have the best opportunity for world class competitiveness and the interests of corporate constituents will be optimally advanced. Our proudest accomplishment will be the emergence of competitors, because investment and informed shareholder involvement are among the most important – and largely unnoticed - assets of the Anglophone world in the coming century.

Endnotes

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[i] Raymond Seitz, Over Here, (Weidenfield & Nicholson, 1998) p. 342.
[ii] Partha Bose and Alan Morgan, Banking on Shareholder Value, The McKinsey Quarterly 1998 Number 2, 97,102,103.
[iii] Davis Global Advisors has ranked the UK #1 for each of the last two years.
[iv] Consider the most recent and most successful shareholder initiative launched by LENS with respect to Waste Management ("WMX"). **Background –** Waste Management was one of the great success stories of post War America. With Wayne Huizinga as one of the founders, it epitomized the vitality of American entrepreneurism. Energetic managers, a good idea, energy, good promotion, a highly valued stock useful for acquisitions, aggressive accounting (more about that later) and – perhaps most importantly – a climate of endless government environmental "reforms" that required constantly changing new standards for handling and storage of waste. As the regulations proliferated, the difficulty for new competitors to enter the industry increased, cost control over required improvements slackened and profit margins soared.

What was wrong – The Great George Soros, for whom we acted in this matter, said "A company can not be Wall Street's darling twice" – and WMX, as it was listed, had been a wonderful performer during the late '70s and '80s. The nicest thing that could be said is that the management had gotten tired. And bureaucratic. And promiscuous in making acquisitions that were not accretive to value. And manipulative in accounting. In March of this year (1998), the company announced a recalculation of its accounting premises with the result that net worth was written down from $4 billion to $1 billion. Yes, that's right. 75% of the book net worth was written off!

Why had the situation been permitted to deteriorate? One of the founders was still the CEO, other founders still held hundreds of millions of dollars worth of stock, and the hand picked successors were in the key managerial slots. Also, trash removal was and remains a good business. It was tough to kill it!

Where was the board? The board of WMX in 1995 was a caricature much beloved by corporate reformers. It had the founder's unemployable inebriate nephew; it had the former Majority Leader of the United States Senate; it had no less than three lawyers whose firms were on the company pay roll; it had agreeing women and compliant minorities; it has "professional directors" who served in many honored positions and never said no. In brief, it was a mess. Everyone liked being on the board; nobody wanted to upset an agreeable situation.

LENS' program. Our efforts to improve this situation are a fairly accurate account of the state of the art in America today. We met with management, presented our viewpoint and became convinced that we would not be accommodated. We prepared for a proxy contest and nominated a slate of opposition directors. As matters composed themselves, the CEO resigned and we were given the chance to name a couple of directors. This we did and Paul Montrone and Steve Miller were the rocks on which change could be based. Competent energy linked to informed and involved ownership generated more change, more new directors. The problem of finding a credible new management was overwhelming, so we were instrumental in generating a take over of WMX by a smaller competitor with the best management in the industry. The deal was consummated early in the summer – and even George Soros has had to admire Wall Street's new darling!

[v] Consider for example the tender of Bank of New York for Mellon Bank in May of 1998. The Mellon management, with the backing of Pennsylvania law, simply declined to consider the offer. And that was that.
[vi] The September 1998 report of the Conference Board, Carolyn Brancato, Editor, points out that the pattern in the U.S. is converging with that in the UK and the largest two dozen institutions have dominant positions in the 1000 largest companies.

[vii] In all of the OECD countries, the central significance of boards is recognized, but what this means and how it is exercised is neither clear nor consistent. The Germans have intellectual purity in having two boards – one supervisory, the other managerial. This functional dichotomy can be expressed as different modes of conduct - monitoring and operating. The U.S. and UK, with a single board structure, require directors to function in different modes when appropriate. This institutional schizophrenia focuses on the American Chief Executive Officer ("CEO" who is usually also the Chairman of the Board) who must devise the agenda and preside the meeting, a significant part of whose agenda is the evaluation of his own performance. The majority of UK board members, subordinate executive directors, must find a way publicly to evaluate their boss' performance. Thus, the Germans have a system that could work[vii]; the UK system requires the suspension of disbelief that subordinates can effectively affront their senior in public; and the American system necessitates a belief in a CEO's competency for and commitment to public self criticism. What I have said is not a secret, it is widely known.

[viii] I would recall the recent example of the Executive Director of GEC who publicly made known his view that Lord Weinstock should retire. That he was correct did not save his job!
[ix] Some of the critics of the Cadbury report shared my skepticism – but for different reasons.
[x] A possible exception is the College Retirement Equity Fund in the United States.
[xi] **Capital trumps nationalism.** That is one message that comes from Daimler Benz's talks with Chrysler and General Electric's purchase of a number of Samsung's core businesses. Prosperity in the U.S., panic in Asia, and unemployment in Europe are eroding powerful attitudes toward "national champions" and barriers to foreign ownership. It would have been inconceivable just a short time ago for the U.S. to sell off one of Detroit's Big Three or for Korea to agree to dismantling one of its chief **chaebol.** Capital has become more powerful than nationalism today. *Business Week*, "Lessons from Our Fast-Changing World", May 18, 1998, p.210.
[xii] Jacques Bughin and Thomas E. Copeland, The Virtuous Cycle of Shareholder Value Creation, The McKinsey Quarterly, 1997 Number 2, 156,167.
[xiii] Accountability must be clear and simple. There cannot be effective accountability to different classes of shareholder. The nature of pension fund beneficiaries as spelled out below most nearly approximates that of society as a whole. There can no question of running corporations for the short term benefit of arbitrageurs.
[xiv] Committee on Corporate Governance, Preliminary Report, August 1997, at Section 5.7.
[xv] The Employees' Retirement Income Securities Act of 1974 ("ERISA") is the federal statute that governs the entire employee benefit system of the United States. It is a federal law that has preempted all state laws.