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Why Do Some Boards Bow to Activists?

Companies in crisis are most likely to replace directors

by Katie Wagner

When shareholders recently capped off weeks of criticism by urging **Chesapeake Energy** and **Yahoo** to replace some of their directors, the boards complied. But at **Forest Laboratories**, where **Carl Icahn** is waging a proxy battle and claiming that the company has underperformed peers by 21% since 2011, the board has refused to settle.

Why do some boards agree to fire members while others resist? Companies that voluntarily replace directors, experts say, tend to be in dire straits. They're also worried that their reputation will suffer unless they shake up the boardroom.

Recent research from **Credit Suisse** suggests that over the past few years more boards have considered their companies to be in situations troubling enough to warrant putting new blood on the board. The percentage of shareholder proxy battles that resulted in settlements rose markedly to 78% in 2011 from 62% in 2010, according to the research. A related finding: The number of proxy fights that went to a shareholder vote collapsed to just 19

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Lead Director Succession Mirrors CEO Search

The smartest boards develop a pipeline of candidates

by Amanda Gerut

Boards are formalizing their approach to appointing new lead directors by taking a page from the CEO succession playbook: developing search criteria based on strategy and the company's needs, seeking guidance from the incumbent, and measuring candidates' strengths against the specified criteria.

Companies including **Aetna**, **Baxter International**, **Corning**, **Dow Chemical**, **Goldman Sachs Group**, **United Continental Holdings** and **Wells Fargo** have all named new lead directors during the past few years as directors stepped down from the position or reached retirement age. And more lead director transitions are likely on the way. **Spencer Stuart**'s 2011 Board Index shows that average tenure in the position for the 202 S&P 500 companies that disclose it is 3.3 years. At those companies, 51% of lead directors have served for two to five years, and 16% have held the position for

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in 2011, from 26 in 2010 and 44 in 2009.

"The only way a slate of directors is recommended to replace several directors would have to be some type of a crisis," writes **Bonnie Hill**, who serves on the boards of **AK Steel Holding**, **California Water Service**, **Yum Brands** and **Home Depot**, in an e-mail. But Hill added a caveat to her statement: "It depends on what you call a crisis."

In some cases, boards let their companies suffer a long string of bad events and negative press reports before allowing shareholders to appoint their nominees to board seats. For example, when Chesapeake's two largest shareholders, Icahn and **Southeastern Asset Management**, called for boardroom reform, their demands coincided with a slumping stock price and heavy criticism from other investors of the company's unresponsiveness to their complaints. In addition, news publications (including this one) brimmed with stories about CEO **Aubrey McClendon**'s financial dealings. Chesapeake's board agreed to replace four directors with people nominated by Icahn and Southeastern.

At Yahoo, shareholder **Third Point** launched a proxy fight earlier this year, mailing a ballot with its own director slate to all Yahoo investors. The move followed declines in revenue and market share, high director churn and several CEO turnovers. Then, Third Point aired suspicions that then-CEO **Scott Thompson** and board member **Patti Hart** had falsified their resumes. Thompson, Hart and four other directors resigned after the suspicions proved true, and the board agreed to appoint three new directors nominated by Third Point, ending the proxy fight.

A spokesman for Chesapeake declined to comment on the recent changes to the company's board, and Forest Laboratories and Yahoo did not return phone calls.

Avoiding Embarrassment

Not all boards wait for a maelstrom of problems before responding to calls for change. At other companies, a single complaint about executive pay can lead to change in the boardroom. "We've definitely had clients who changed their compensation committee's composition because their shareholders asked them to replace their compensation committee members in light of their executive pay having been excessive or not sufficiently performance-based," says **Bill Ultan**, a senior managing director at **Morrow & Co.**, who advises boards and management on corporate governance and proxy issues.

And **Hank Boerner**, who has been advising Fortune 500 boards for decades on crisis management and other issues, says companies sometimes settle with a shareholder seeking board seats because they want to avoid the negative media attention that could result from a contested director election. Boards whose directors hold C-level titles or directorships at other public companies tend to be even more responsive to such shareholders, he adds.

"It's embarrassing to have a shareholder demanding something — that at some point you may agree to do anyway — be a contentious element in your annual meeting," Boerner says.

But a company need not be troubled for the board to refresh its membership. Most board's nominating and governance processes include a means for shareholders to submit board candidates for consideration, regardless of whether the company is facing a problem or not, writes Hill in an e-mail. Home Depot, for instance, invites recommendations from its investors when the board has a vacancy.

And some boards change their membership in response to shareholder requests for greater diversity of gender, race or experience, says Ultan.

No Gadflies

Of course, there are many circumstances under which most boards would avoid settling with a shareholder seeking to replace directors. For instance, if a shareholder tries to win board seats to facilitate a hostile takeover or to force a strategic change, like spinning off a profitable division, the board might prefer to let a contested election run its course, says Ultan.

Boards also typically fight shareholder attempts to remove particular directors when they feel such directors are being unfairly targeted, he says.

Barbara Alexander, a director at **KB Home**, **Allied World Assurance Company Holdings**, **Qualcomm** and **Choice Hotels**, says she has never served on a board that consented to giving seats to a gadfly shareholder who held an insignificant stake in the company.

Fortunately, no regulations dictate when a board is absolutely required to honor a shareholder's demand for new personnel. "Each situation is different, the dynamics in the boardroom are different at each company, and they really reflect the culture of the company," says Boerner. ■

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