

European institutional investors winning corporate governance reforms in US investee companies



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Institutional investors, long accused by critics of failing to exert their ownership responsibilities over their investee companies, are now beginning to take action. The focus is primarily on corporate governance issues: board composition, its independence from executive management, and executive pay being chiefly promoted. And more, the drivers of this are, for the most part, European, with the targets increasingly overseas, notably from the US. These and other issues related to active ownership were discussed at a high-level conference of institutional investors held in Amsterdam on 16 March 2006. The event jointly hosted by Schiffrin & Barroway, LLP and Institutional Investor brought together over 100 leaders of institutional investors, with over \$1 trillion of assets under management, to debate and discuss forward-looking themes with acknowledged 'active ownership' experts from around the world. What follows builds on the issues raised at the Amsterdam event.

The drivers of active ownership

Financial market liberalisation and deregulation, the abolition of cross-border capital flow restrictions, the single European currency, technological innovation, along with the financing needs of aging societies, all lie behind the unprecedented growth of institutional investors, including pension funds, mutual funds, insurance companies, and their asset management firms. There has been a commensurate expansion in their size. For example, the largest 300 US institutional managers now hold \$7.5 trillion of equities, 56% of the stock market's capitalisation, while the largest 100 own 52% of all shares.¹ Total assets of US pension funds and life insurance investments stood at \$13.4 trillion in 2004, equal to 115% of GDP. Australia, Canada, Denmark, the Netherlands, Switzerland and the UK have recorded comparable growth.

The old notion of corporate ownership being dispersed around a myriad of disinterested owners no longer holds true; institution-

¹ John C Bogle, *The Battle for the Soul of Capitalism*, p 74, Yale University Press, 2005.

al investors now own ever larger shares of individual companies. What's more, these investors have outgrown their own markets and are now investing across borders at an unprecedented level, with the prime target being US companies. This trend was referred to in Amsterdam by Daniel Summerfield of the UK-based Universities Superannuation Scheme. He noted that his fund's majority holdings were now invested in companies domiciled outside of the UK, and yes, with a large US contingent.

The superficial answer as to why these institutions have become active owners is: because they can. They have the financial muscle and they own the companies. Though necessary, these conditions are insufficient: what's dramatically different today is twofold. First, societies' expectations have changed – people want their retirement income and other savings to be invested in companies that are governed well and act in a socially responsible way – and trustees are investing accordingly. Within that, the boundaries of fiduciary duty have shifted to include corporate governance (primarily), as well as social and environmental concerns.

Second, institutional investors have developed a sophisticated 'tool box' to implement active ownership, supplemented by a burgeoning support industry. The tools in the box range from:

- 'engagement', which includes letter writing and face-to-face meetings with management and (increasingly) directors;
- tabling and voting on resolutions at AGMs, and ensuring that proxies get voted; and
- litigation now a reality for active owners (especially in the US).

As important, institutional investors are working together as never before, and this extends across borders. As to the support industry, proxy voting companies have flourished, alongside corporate research consultancies, all using ever more advanced corporate governance metrics.

It appears that European investors (and Australian too) have more readily taken on an active ownership role, relative to their US cousins. They have honed their skills domestically, as the European corporate landscape is more conducive to this, while the US has more resembled a battleground, with entrenched corporate management viewing even limited engagement as an affront to their autonomy and power. In these circumstances, and as European investors are finding, litigation is often the only recourse left to frustrated US investors.

The immovable force of US companies meets the immutable power of institutional investors

European investors venturing into the US market are usually shocked to find that the ownership rights that they take for granted at home are virtually non-existent. For example, they have no statutory right to nominate and elect directors. They may withhold their vote from candidates on a management slate, but the 'cumulative' voting system that dominates US governance requires management-supported directors to muster only a handful of supportive votes to ensure their election. Staggered board elections are a further management tactic to entrench their can-

didates. Management may, and frequently does, block investors from placing resolutions on the proxy form, and are not required to include investors' information to be disseminated prior to an AGM, creating a crippling financial hurdle for investors to overcome. Moreover, resolutions passed by shareholders at AGMs are not even binding on management, they are merely advisory.

Faced by such management intransigence, European active owners are finding that their engagement tactics have to be supplemented by tools more appropriate to achieving their corporate governance ends. And in the US context that means litigation, of which Rupert Murdoch and the board of News Corporation are but the latest high-profile targets of this type of action. Two approaches are available: mainstream securities class actions, where corporate governance reforms may be negotiated as part of the overall financial settlement; and shareholder derivative actions, whereby investors sue the executive officers on behalf of the corporation, to achieve corporate governance relief.

Securities class actions create economic incentives to improve governance

The venerable aphorism "money talks" neatly summarises the basis for European institutional investors' increasing participation as lead plaintiffs in US securities class action litigation. When institutional investors sustain significant economic losses as a result of financial fraud, they have two different but related interests: recouping as much of their losses as possible, and correcting the breakdowns in management and governance that allowed the fraud to take place. Particularly for institutions whose investments are largely indexed, 'voting with your feet', ie, liquidating a position, is not an option. Therefore, institutional investors have a strong interest, a responsibility even, not only to recoup past losses, but to take action to promote and protect investor value going forward.

As a lead plaintiff in a securities class action, an institutional investor with a significant position in a US corporation can bring to bear both its economic and legal power to create change. In the US context, securities class action litigation is one of the most powerful and effective tools in the institutional investor's tool box because it has real economic consequences for management. Faced with multi millions or billions of dollars in potential liability for securities fraud, management becomes far more attentive to the corporate governance concerns of the corporation's institutional owners. When the time comes to sit around the bargaining table to work out a settlement, management has a strong economic incentive to improve corporate governance in a manner satisfactory to the lead plaintiff.

Corporate governance reforms that have been included in settlement agreements range anywhere from altering the composition of the audit committee to revamping a corporation's overall structure. For example:

- Siebel Systems settled a class action suit in 2003, and agreed, in part, to significant oversight reforms that included expanding the number of board members and requiring more disclosures about executive remuneration;
- Enterasys Networks settled a shareholder class action and, as part of the settlement, agreed to allow investors holding more than 5% of the company's stock to nominate alternative candidates to the board and to provide more information on executive remuneration;
- Sprint Corporation settled a shareholder suit and, as part of the settlement, agreed to revise the composition of the board, ban insider selling during company stock buyback programmes, and require independent directors to meet at least twice a year outside the presence of management.

Shareholder derivative actions directly target corporate governance reform

Corporations that commit massive financial frauds are obvious candidates for corporate governance reform, but they are not the only US corporations that have governance issues. Many corporations that are in compliance with US securities laws nevertheless exhibit poor corporate governance, particularly in the area of executive remuneration. In this situation, shareholder derivative litigation may be the appropriate tool to draw from the tool box.

Under US corporate law, management and the board of directors generally have the exclusive authority to pursue legal claims on behalf of the corporation. However, where management and the board are the wrongdoers against whom the corporation would press its claims, shareholders may 'step into the shoes' of the board to pursue claims on the corporation's behalf. That is, the shareholders' ability to sue management is 'derivative' of the board's legal authority – hence, shareholder derivative litigation.

In the US, shareholder derivative litigation typically focuses directly on deficiencies in corporate governance, including excessive executive remuneration and other management self-dealing, poor internal accounting controls, and conflicts of interest or lack of diligence among board members. The primary goal of most shareholder derivative litigation is to improve corporate governance for the benefit of the corporation as a whole and, ultimately, its shareholders.

As in securities class actions, settlements in shareholder derivative actions can include a wide variety of corporate governance reforms. For example, the officers and directors of Fairchild Corporation were sued in a shareholder derivative action that focused on excessive remuneration and perquisites and related-party transactions involving its chairman/CEO Jeffrey Steiner and other company executives. In the settlement, Fairchild:

- reduced Steiner's compensation by 50%;
- created a new oversight committee to oversee and pre-approve related-party transactions; and
- reformed the company's executive remuneration practices by requiring that regular and bonus remuneration be directly related to the company's performance and prohibiting senior executives from receiving non-compete and consulting payments.

Conclusion

Active ownership takes many forms, and responsible institutional investors have several tools in their tool box from which to choose. As in any project, the key to success is choosing the right tool for the job. When it comes to improving governance of US companies, securities class action and shareholder derivative litigation are often the most effective tools to accomplish the task. As the leaders of the active ownership movement, European institutional investors should continue and expand their use of these tools to assist in achieving their goals. ■

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