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Corporate governance
Anything you can do, Icahn do better

The pressure on companies from activist shareholders continues to grow

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TIM COOK'S nightmare is over, but John Donahoe's has just begun. On February 10th Carl Icahn, the godfather of activist shareholders, ended his campaign to get Mr Cook, the boss of Apple, to return some of its $160 billion cash mountain to shareholders through share buy-backs. Mr Icahn declared victory, although Apple is not handing back as much of its cash as he had wanted. His next target is eBay, which he is pressuring to spin off PayPal, its online-payments business. Mr Donahoe, eBay's boss, has told Mr Icahn to get lost, but surely knows he cannot brush off the pugilistic investor so easily.

A visit from an activist shareholder is now a possibility for any publicly traded company: if not the 77-year-old Mr Icahn, then one of the growing army of younger imitators he has inspired. Mr Cook was first put under pressure to "stop hoarding cash" last year by David Einhorn, boss of Greenlight Capital, a hedge fund. Having shaken up Yahoo's management and strategy in 2012, Dan Loeb and his fund, Third Point, have turned their attention to Sony, calling for it to separate its electronics and entertainment arms; to Sotheby's, an auction house they want to repurchase shares; and to Dow Chemical, which they want to shed its petrochemicals business.

Nelson Peltz, who has been a shareholder activist almost as long as Mr Icahn, last month joined the board of Mondelez, a snacks business he had targeted. TCI, a London-based fund run by Chris Hohn, has rediscovered its activist mojo after having been badly hurt by the financial crisis. Last year it urged EADS (now Airbus Group) to sell its military-planes business, and took on the management of Japan Tobacco. Steve Ballmer was helped on his way out of Microsoft's top job by ValueAct Capital, run by Mason Morfit.

Last month Bill Ackman's Pershing Square made a tasty profit when Suntory acquired Beam (the maker of Jim Beam bourbon), which had been spun out of Fortune Brands as a result of his activism. But Mr Ackman has also demonstrated that activists have no monopoly on wisdom: Ron Johnson, the new boss he lobbied for J.C. Penney to install in 2011, made things worse at the struggling retailer, and lasted just 17 months. Mr Ackman has been at loggerheads with Messrs Icahn and Loeb over Herbalife, a nutritional-supplements business. Mr Ackman has shorted its shares, calling the firm a "pyramid scheme" (a charge Herbalife denies). His rivals have gone long on them. So far, Mr Ackman is out of pocket.

The activists' growing influence has many causes, including rule changes that have given shareholders more voting power and have made institutional investors cast their votes more thoughtfully. Social media have made it easier for activists to mount a campaign: Mr Icahn now tweets like a budgie on speed. And, says Bob Monks, a campaigner for shareholder rights, Mr Icahn has had a huge impact by "making it clear to the greediest people in the world that you can make a lot of money out of activism".

It is the way these profits are made that is the focus of the activists' critics. Activists usually buy a block of shares, make a public call for change and lobby management and other shareholders to implement it. When they do, the activists sell at a profit. Martin Lipton, a lawyer who has long helped protect incumbent management, not least by inventing the "poison pill", a potent defence against takeovers, argues that activists encourage firms to do things that boost their share price in the short run but harm their long-term performance. This critique has plenty of adherents, in academia, business and government.

Where's the evidence?

Yet empirical proof that activists exacerbate short-termism is strangely elusive. Indeed, such evidence as there is suggests the opposite. "The Long-Term Effects of Hedge-Fund Activism", a recent paper by Lucian Bebchuk of Harvard Law School and others, examined the roughly 2,000 interventions at companies by activist funds from 1994 to 2007. Over the five years following an intervention both the share price and the operating performance of the target company improved, on average. The operating performance got stronger towards the end of the five-year period, not weaker.

This is the sort of evidence that has convinced Mary Jo White, the chairman of America's Securities and Exchange Commission, to argue in a recent speech that activist shareholders should no longer be automatically viewed negatively. These days, she said, "There is widespread acceptance of many of the policy changes that so-called 'activists' are seeking to effect."

A recent article in the *Columbia Law Review*, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights", argues that the activists have become a vital adjunct to the institutional investors who own most shares, and who are "willing to respond to governance proposals but not to propose them". Activists have thus become "governance intermediaries", who find underperforming firms and offer their managers and institutional shareholders "concrete proposals for business strategy through mechanisms less drastic than takeovers".

So it is crucial, the authors argue, to pass reforms that help the activists do their job. Mr Lipton and others are pressing for a rule change that would have the opposite effect, by obliging activists to disclose stakes at a lower threshold (2% of a firm's shares rather than the current 5%) and more quickly (within a day rather than the current ten). That would force them to show their hand before they had built a big enough stake to make a decent profit if and when their proposals succeeded.

Boards have an obvious motive to back curbs on troublesome activists. But a better strategy—and one that big firms are increasingly adopting—is to talk to them, consider their ideas and even invite them or their representatives to become directors, as firms from Microsoft to Mondelez have done. If a board's strategy is in fact better than that proposed by the activist, having the debate in public may strengthen the incumbent management, as happened when activists took on firms such as AOL, Target and Clorox.

Indra Nooyi, the boss of PepsiCo, chose to work with Ralph Whitworth, a veteran activist who took a stake in the company. By doing so she was able to head off calls for a break-up of the firm (led by Mr Peltz), while still boosting its shares, thereby restoring her authority. Mr Donohoe's encounter with Mr Icahn may prove less nightmarish if he treats his ideas about eBay on their merits rather than dismissing them out of hand.

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