Retaking the High Ground.

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When private investor Daniel Snyder barged into the affairs of stumbling amusement park operator Six Flags last August, he wanted to shake things up by replacing three directors ahead of the company's next annual meeting this July. He picked the right venue for such a fight: The State of Delaware, where Six Flags is incorporated, allows shareholders to initiate an action outside the annual meeting via a procedure called "written consent," unless a company specifically disallows that in its bylaws. Six Flags had no such preventative measure, so Snyder, a hardball investor who also owns the Washington Redskins, plunged ahead. Not only did he get three directors on board; he also got himself named chairman. Now Snyder is calling the shots at Six Flags, along with his handpicked CEO, Mark Shapiro, a programming wunderkind who turned ESPN on its ear.

The battle at Six Flags is part of a larger war being waged these days across corporate America as some investors, mostly hedge funds, recast themselves as "activists" and fight for more say in the fate of target companies, despite holding what is often a relatively minor stake. These investors are demanding change on a gamut of issues, ranging from the specific, such as telling a company how to spend its cash reserves, to the sweeping, such as instituting majority voting (most directors are elected by a plurality, even if one shareholder votes and 99 abstain) or even the outright sale of the company.

But the rules and indeed the playing field have changed. No longer are skirmishes won or lost through bear hugs or tender offers, as they were in the 1980s, when activists were chiefly corporate raiders. Now, the battles are often fought within the framework of corporate governance, using the weapons of public opinion, lobbying and the court system all in the cause of effecting change that ostensibly benefits the company-and certainly benefits the investor.

The activists have become increasingly skilled in the use of these tactics. While the number of proxy fights has remained relatively flat, the percentage of dissident victories (including outright and partial victories as well as settlements) has ratcheted up to 59% so far in 2006 from 48% last year and only 40% in 2001, according to FactSet TrueCourse, a takeover defense research firm that operates SharkRepellant.net.

This turn of events has many a corporate chieftain apoplectic. They point out, with some justification, that many of the new activists are simply raiders in respectable clothing-short-term investors who take positions in companies, make demands, and are out again when their demands have been met--showing no real concern or interest in the long-term viability of those companies. What is more, hedge funds, which control $1.5 trillion in global assets, are but one leg of what one banker calls an "ironic trinity" of forces

assailing the corporate world: The others include the hundreds of billions of private equity dollars looking for deals, and the dozens of Wall Street firms poking about on the periphery for underwriting or advisory mandates.

Each of the three can operate as distinct entities, or together. "Activist shareholders are not necessarily good or bad," says Paul Taubman, Morgan Stanley's global head of M&A, and the distinction between "black hats versus white hats" is not always clear, he adds.

What's a CEO or a board to do in such a combustible situation? Can it simply remove hedge fund investors from the picture, or lessen the impact of their presence? The answer to the former is obviously no, but the answer to the latter is surprisingly yes, corporate governance attorneys say. Companies can indeed proactively make changes and adopt strategies that will lessen the impact of investor demands (see sidebar), including the adoption of bylaws that limit a shareholder's ability to call a special meeting and/or require advanced notice for board nominations and other shareholder proposals, or even something as basic as making certain that key ratios such as compensation and return on equity are within the average ranges for their industry.

"It's a very different game now," says Gary Lutin, who runs Lutin & Co., which advises investors in corporate control contests. "Corporate control contests are now essentially voting contests, just like politics." He says managements that want to keep their jobs and their companies intact need to focus on a range of very different constituent interests, including not only the traditional Wall Street concerns about return on invested capital, but also pension funds that are concerned about good governance policies and foundations that are concerned about social issues. "This is the way global capital markets are evolving, and this is the way survival will be decided," Lutin says.

In short, the public relations battle has become key. And in that regard, corporate chieftains may have been slow to wise up, but some are starting to get it. Thanks to lobbying by corporate executives, European regulators are now examining ways to mitigate hedge funds' outsize influence on companies' futures. Among the changes: Germany's decision last month to force shareholders to make a disclosure filing after accruing 3% rather than 5% of common shares, and a review by the Dutch senate of new rules that would make it harder for hedge funds to band together to force change on a company.

The new game

The new battles often begin with activists advancing what seems like a reasonably progressive agenda, though few go all the way to making a hostile offer. While there have been only about 30 hostile takeovers in the US during the past five years, activist campaigns number in the hundreds, according to SharkRepellant.com.

While defense lawyers say that the best shield is a strong performance and a sparkling share price, the reality is that most companies have some vulnerability. The problem is, many don't seek advice until late in the game.

Even then, they may find that such time-honored defenses as poison pills and staggered boards have lost some of their punch. Both can be viewed as poor corporate governance and a naked attempt at entrenching management-and thus grounds for criticism. As a result, both of those defenses are being used less often. At the end of 2002, 61% of S&P 500 companies had a pill and a staggered board, while today the figure is 45%, according to SharkRepellent.net.

Other procedural defenses are becoming more important, such as limiting shareholders' ability to call a special meeting or act by written consent. These measures may seem thin, but they have a purpose in an environment in which activists rarely try to buy an entire company. Rather, what the raiders often look for is board representation, which gives them greater standing to steer the company to divest assets, shed poison pills or buy back stock. "What a company is generally trying to do now is limit its exposure to the annual meeting, where these activists can come after them," says John Laide, research manager at FactSet TrueCourse.

A case in point is Houston Exploration, which sold offshore assets early this month and laid out its plans for the $800 million of expected proceeds, including a share buyback and possible onshore acquisitions, among others. But no sooner had Houston Exploration announced its plans than hedge fund Jana Capital entered the fray, launching a campaign to have Houston spend the entire sum on a share buyback. It pressed its case to other shareholders, asking them to withhold votes. More than a third of votes were withheld, but Houston Exploration did get its board re-elected. Still, Jana considered such a show of dissidence a win, and a sign of things to come. In a May 8 letter to the independent exploration and production company, Jana managing partner Barry Rosenstein wrote: "You can do the right thing for shareholders now by instituting a substantial share repurchase as we have described, or you can continue to ignore shareholder demands and face an unhindered campaign next year in which shareholders will be free to replace you." The company declined to comment.

Banks' dilemma

Why have there been so many successful agitation campaigns? The reasons are several. The biggest and most obvious: Sarbanes-Oxley, whose restrictions have injected a dose of caution, conservatism and downright nervousness into boards and have heightened shareholders' awareness, bankers say. Sharply rebuked after the Enron and Worldcom debacles, boards now tend to react much more quickly to shareholder concerns. That plays into the hands of activist hedge funds that start a campaign, particularly one with a tie to shareholder rights, that immediately puts a board under a microscope and sometimes forces it to agree to certain demands.

At the same time, hedge funds are not only bold and well financed; they have also proved themselves adept at seizing the high moral ground in these battles as they seek better governance, no matter how short-term their intentions are.

The biggest criticism, of course, is that such shareholders have little concern for the long-term well-being of the company. US companies, in particular, have missed a public relations bet by not being more organized and vocal in their objections to the tactics of hedge funds. Some may also be making themselves an easy target by allowing obvious missteps to exist, such as outsize executive pay compared with compensation at more profitable peers--that is precisely what triggered the ongoing battle at Home Depot. But the delicacy of the situation is not lost on investment banks, which have to weigh the concerns of their corporate clients against the profits to be made from participating with or advising activists.

There are other banking conflicts, the chief one being that almost all large banks have lucrative prime brokerage arms that provide a range of services to hedge funds-from loans to trading-that often enable those funds to acquire the stakes they later use as a platform for action. Still, banks seem to think twice before helping those funds in their agitation battles.

Several banks, including Morgan Stanley and Goldman Sachs, have come out generally on the side of corporations, saying they are interested in advising acquirers that want to buy entire companies, not small stakes for short-term gain.

On the other side of the spectrum is Lazard, which earlier this year helped Carl Icahn pressure the board of Time Warner to take certain measures such as a stock buyback to try to give some life to its sagging share price. At a press conference, Lazard's CEO appeared with Icahn, and the two unveiled a tome that ran to 300-plus pages that spelled out the case against Time Warner. Icahn retreated after Time Warner agreed to some of his suggestions, including a $20 billion buyback, up from $5 billion originally planned. All the machinations had little effect on Time Warner shares, which edged up to $18 from $17.

Morgan Stanley may have aligned itself with companies, but it says it has not ruled out working with shareholders who are there for the long haul. In fact, its own asset management arm, which has held stock in the New York Times Group for 16 years, earlier this year called on the newspaper publisher to abolish its dual-class shares. (That incident also points up the fact that hedge funds aren't the only shareholder entities calling for change. Indeed, Fidelity was a major force in getting Dutch publisher VNU to drop its bid for IMS Health last year.)

"We advise a whole array of parties buying and selling companies with the goal of enhancing long-term shareholder value," Morgan Stanley's M&A chief Taubman says. "The fact is many of these hedge funds have no interest in buying or selling a company or creating long-term value. On that basis, what they are seeking is inconsistent with our M&A practice."

UBS is certainly interested in strong relations with hedge funds, having established a new investment banking group last year to develop its business with them. But when it comes to M&A, UBS says it weighs every situation carefully and has not ruled out working for those holding partial stakes. "Some firms we compete with have taken an adamant adverse position against advising hedge funds in an M&A context," says Jeff Raich, joint global head of M&A at UBS. "We take a balanced approach in evaluating how we approach these situations."

The short-term versus long-term debate is sometimes not as clear-cut as it seems. For example, Lucian Bebchuk, a professor at Harvard University, has advocated majority voting instead of the plurality vote that many US companies have. He argues that it is easier to manipulate the outcome of a vote in a plurality system, in which a director can be elected with as little as one vote. Majority voting, on the other hand, would help ensure that the goals of activists were aligned with other shareholders, since a large block would have to be convinced that the new way makes sense.

"It's new techniques, new ways of framing the debate, but the same short term versus long term," says David Brown, partner and co-head of the financial services practice at the law firm of Alston & Bird in Washington, DC.

"Who is making the argument is less interesting than the merits of that position," says Greg Taxin, CEO of research firm Glass Lewis. Still, he adds, "we are skeptical of short-term interlopers who claim to have a better approach to running a company than the current management team, but aren't seeking to buy the entire company." If they really know the business that much better than current management, he says, "what they ought to do is buy the place and do their magic."