

Strategy & Corporate Finance Practice

# Investors remind business leaders: Governance matters

Activists continue to poke holes in corporate performance and returns, but they are having their greatest success with governance structures. Here's how to think about their moves.

*by Michael Birshan, Madeleine Goerg, Anna Moore, and Ellora-Julie Parekh*



**Even before the spread of the novel coronavirus,<sup>1</sup>** investors were calling on senior-management teams and corporate boards to focus on environmental, social, and governance (ESG) concerns. Investors were, for example, prompting companies to consider questions of purpose and to pay more attention to the impact of their actions on the environment. Now the pendulum is swinging toward social issues raised by the spread of COVID-19—for instance, worker safety and rising unemployment.

For many businesses, governance remains a less discussed area of vulnerability, in part because it involves internal systems, controls, and procedures, which in many cases are less visible to stakeholders and the broader public. For instance,

stakeholders cannot always tell if boards and senior-management teams are preempting regulatory violations or communicating clearly with regulators, above and beyond standard reporting—until it is too late.<sup>2</sup>

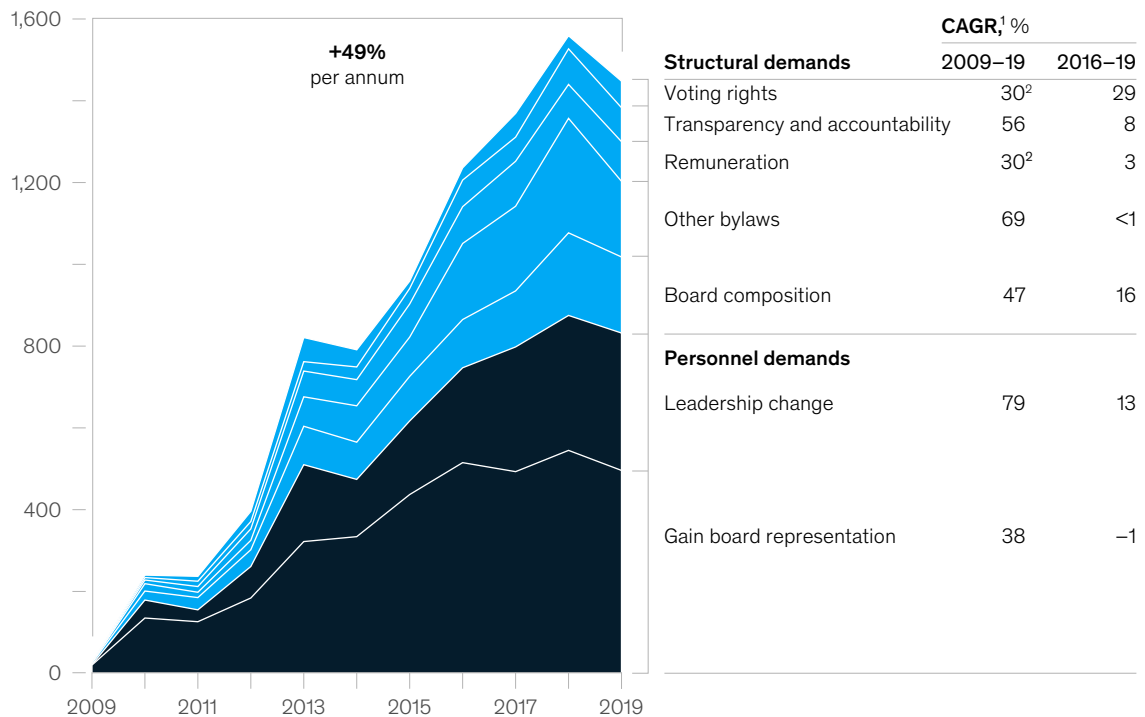
In the wake of the global pandemic, boards play a key role in guiding their organizations into the next normal. Indeed, this may well be the moment when boards and leadership teams prove their value—or show their flaws.

Companies that do not regularly review and address governance issues may be ignoring them at their own peril. Governance-related demands by activist investors around the world rose from just 27 in 2009

Exhibit 1

## Board- and governance-related campaigns by investors have increased significantly.

Demands by type, number



<sup>1</sup>Compound annual growth rate.

<sup>2</sup>2010–19.

Source: Activist Insight

<sup>1</sup>"COVID-19: Implications for business," June 11, 2020, McKinsey.com.

<sup>2</sup> Witold Henisz, Tim Koller, and Robin Nuttall, "Five ways that ESG creates value," *McKinsey Quarterly*, November 2019, McKinsey.com.

to around 1,400 in 2019. These demands reflect activists' interest in a broad range of sectors, including the financial-services, basic-materials, energy, business-services, and technology sectors (Exhibit 1).<sup>3</sup>

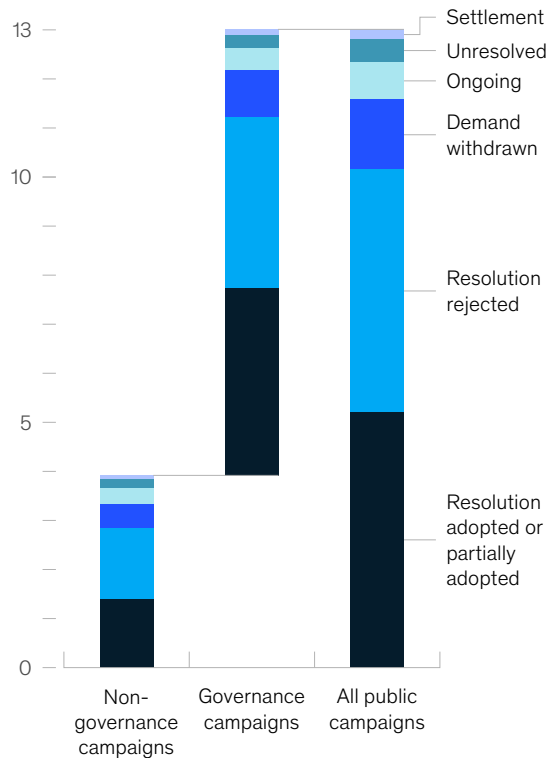
What's more, about 70 percent of *all* activist-investor demands over the past decade have focused on governance, and many have garnered support from proxy advisers.<sup>4</sup> Governance is also increasingly top of mind for institutional investors.

Activists' demands fall into two broad categories—structural and personnel-related—and cover a range of issues, including board composition, remuneration, accountability, voting rights, and leadership changes (see sidebar, “Two categories of concerns”). Governance-related demands have not only outnumbered others over the past decade but also more successfully achieved their targeted outcomes (Exhibit 2).<sup>5</sup> A typical example of such demands involves a manufacturer's delay in disclosing a transaction appropriately, as well as accusations that its

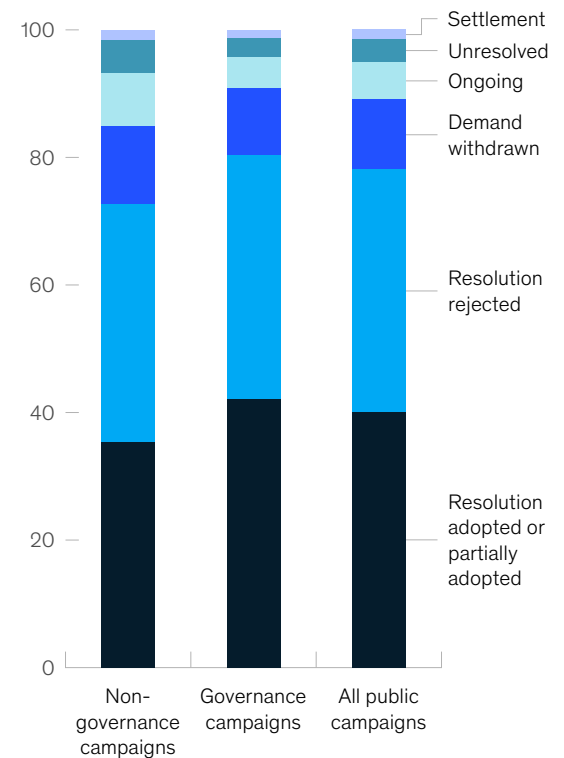
Exhibit 2

### A significant number of governance-related campaigns have been successful over the past decade.

Demands by type and outcome since 2009, thousand



Demands by type and outcome since 2009, % share



Source: Activist Insight; Proxy Insight

<sup>3</sup> Activist Insight Governance Module, 2009–19, [activistinsight.com](http://activistinsight.com).

<sup>4</sup> Activist Insight Governance Module, 2009–19: 9,093 governance-related demands and 3,919 nongovernance-related demands. In the 2017–18 voting season, ISS and Glass Lewis supported most governance-related proposals from shareholders during shareholder meetings. In 2017–18, ISS and Glass Lewis supported 75 percent and 88.5 percent, respectively, of shareholder proposals for independent board chairs. Both supported 100 percent of proposals to adopt majority voting for director elections. Proxy Insight 2019, [proxyinsight.com](http://proxyinsight.com).

<sup>5</sup> In the past decade, more than 42 percent of governance-related resolutions from shareholder activists were adopted, compared with 35 percent of nongovernance-related resolutions. Activist Insight Governance Module, 2020.

## Two categories of concerns

**Our research shows** that activist investors' corporate-governance concerns, while many and varied, tend to fall in two broad categories: structural or related to personnel.

Demands relating to structural concerns typically focus on the following five areas:

- *board composition and independence*—the annual election of directors, the introduction of minimum requirements for the number of independent directors, changes to the number of board seats, and transparency about who is being appointed to top positions and about succession planning
- *remuneration*—the proportion of long-term incentives in executive compensation; the introduction of incentives related to environmental, social, and governance issues; and benchmarks for executive

compensation, options, bonuses, and expense accounts

- *transparency and accountability*—changes in the auditing process or in the disclosure of financial statements, additional information on transactions, access to shareholder lists, and the results of internal investigations
- *voting rights*—majority voting at shareholder meetings, the amendment or repeal of poison-pill or shareholder-rights plans, and the implementation of a universal proxy card so shareholders can vote for individual director nominees or oppose proxy contests for board seats
- *other bylaws*—the threshold for calling special shareholder meetings, as well as proxy-access bylaws that require a company undergoing an election to include on the voting list the name of

any person who meets agreed-upon ownership criteria and has been nominated by a shareholder

Proposals focusing on personnel-related concerns are typically related to the performance of individuals or teams. They challenge a company's stewardship by demanding such things as these:

- *board representation*—improving oversight and diversity by challenging the expertise or independence of individual candidates put forward for election
- *leadership change*—requesting the removal of senior executives or board members for failures of performance or campaigning to separate the roles of the chair and the CEO to increase checks and balances

executives had bought votes. These actions opened it up to a two-year shareholder-activist campaign culminating in the company's breakup.

As the manufacturer and many other companies have learned the hard way, it is always better to be your own activist rather than have demands thrust upon you. Executives and board members should respond to increased external pressures by continually reviewing their governance efforts and considering the best ways to shore up their governance credentials. These efforts have an added bonus: a strong governance program can promote success in many other parts of the business—including improved operations, motivated talent, and

increased innovation—and can strengthen shareholder relations.

In this article, we'll examine the primary governance factors that activist shareholders have targeted and the ways in which some of their concerns were mitigated.

### Quantifying the concerns

Not all governance proposals from shareholders are created equal. It is important for companies to quantify the number and type of possible activist overtures. Some of them focus on improving management fundamentals, others suggest board

or leadership changes to give activists seats at the table, and still others propose what may be sensible measures for unlocking value.

Data from Activist Insight show that personnel-related demands—to gain board representation or changes in leadership, for instance—have accounted for more than 40 percent of all governance-related proposals since 2009. The other 60 percent or so have focused on structural concerns. An industrial, for example, faced an internal investigation after several quarters of operational issues. It then decided to delay the announcement of quarterly results. These problems and a related decrease in share price prompted activists to demand more frequent earnings disclosures and the election of independent external directors to the board. The manufacturer swiftly agreed, and the end result was greater transparency and, ultimately, increased corporate value.

### **Shoring up governance credentials**

Frequent governance reviews are not only a good hedge against demands from activist investors and other shareholders but also simply good corporate hygiene. Companies often do not conduct such reviews because management teams are under less pressure to focus on these capabilities than on others. What's more, the acknowledgement of the direct links between good governance and value creation is a recent development in many companies. Our research and experience in the field suggest that businesses can take several steps to anticipate activists' concerns and shore up their governance credentials.

#### **Change the board's composition**

Activist shareholders are demanding more diverse, expert, committed, and independent boards. Rising shareholder expectations are prompting companies to bring in new profiles, adjust the sizes of boards, or review board-member terms and renewals. For similar reasons, a large company under pressure from activist shareholders cut its directors' terms to two years, from three, and reduced the size of its board to nine members, from 11. As a result of this board shake-up, four long-standing board members will step down by the end

of 2020 or 2021 to allay concerns over a lack of sector-specific expertise and independence from the CEO.

Companies should not wait to be prompted by activist shareholders; rather, they should create a more inclusive and professional board by proactively adding to (and, if appropriate, shaking up) the current composition of the group, clarifying expectations for board members, and reviewing its level of engagement. Such reviews could include a detailed comparison between the current directors' skills and a "competency matrix" (the skills the company deems critical). They could also consider the directors' prior affiliations with the company, potential conflicts of interest, and the board's overall responsiveness.

#### **Clarify your remuneration policy**

Shareholders increasingly want to understand how senior management and boards have arrived at levels of leadership remuneration and whether it is fair. They are asking, for instance, if it is tied to performance or to specific ESG metrics or if it is in line with remuneration at peer companies. Aiming to align pay with performance, activist shareholders of one industrial conglomerate pushed to change the performance targets for all top executives. The activists sought to cut the bonuses for those executives whose businesses had recorded losses in 2017, including those of the CEO and CFO.

To anticipate activists' concerns about pay and performance, companies can, for instance, ensure that they have clear and communicable metrics that support their decisions on remuneration. Reacting to a public ESG campaign by a group of shareholders, a major oil and gas company decided to link the compensation of more than 1,000 top employees to its success in meeting reduced carbon-emissions targets.

#### **Communicate clearly**

When companies are involved in major transactions, investigations, or audits, shareholders look for full transparency. In one large company, shareholders stepped in to demand a governance overhaul given their concerns about an acquisition decision made by the board. As a result, the company

ended up creating a board-level committee to consider the interests of noncontrolling shareholders in all major decisions.

To limit speculation and dispel concerns, it is critical for senior management and boards to give stakeholders a coherent narrative about major decisions and the potential effect on corporate performance. Establishing a rhythm of clear, frequent, and comprehensive updates on such decisions, as well as a mechanism for disseminating follow-on reports and metrics to key stakeholders, can help allay shareholder concerns.

### **Think about the rules of shareholder engagement**

Given the pace of change in business and the world today, shareholders are demanding that companies adopt faster decision-making processes. Reviewing how shareholders participate (for example, by testing how voting rules affect shareholder engagement) can help keep up with changing shareholder expectations. A majority vote, for instance, is becoming the standard for board elections. According to Spencer Stuart's 2019 board index, 89 percent of boards in the US require directors to resign if they fail to receive a majority of the shareholders' votes, compared with just 65 percent in 2009.<sup>6</sup> More and more companies must also submit proposals for poison pills, takeover defenses, and other matters for ratification by shareholders.

### **Circle back to purpose and societal impact**

Shareholders and stakeholders in all sectors continue to make it clear that the impact of any business on the environment and society matters to them. The decision by a large commodity-mining and -trading company to cap its global coal output, for instance, was directly linked to shareholder pressure to align with the targets of the 2015 Paris Agreement. To head off the activists' concerns, senior-management teams and boards can regularly review their portfolios of business activities and map the impact on major global initiatives. A growing number of companies benchmark themselves against the UN's Sustainable Development Goals, for example, thus actively positioning themselves to attract top talent and socially conscious consumers and to meet critical regulatory requirements.

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With activist investors and other shareholders increasingly focused on stewardship, now is the time to evaluate where you stand. A governance review should form a big part of any program to prepare for and engage with activist investors.

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<sup>6</sup> "2019 U.S. Spencer Stuart Board Index," Spencer Stuart, October 2019, spencerstuart.com.