Shareholder Activism: A Multi-Dimensional View of a Conflict-Ridden Construct

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Abstract

We contend that shareholder activism is a conflict-rich construct given the heterogeneity of actors involved and the divergence of motives and interests of firm managers, shareholder investors, and proxy advisors. Proxy advisors, an exogenous actor that interacts with both shareholders and firms, suffer from rampant conflicts of interest affecting negatively investors and beneficiaries alike. Pointing at goal incompatibility as a tension generator, agency theory provides a context for understanding the inherent friction between key actors at the opposite ends of the table – shareholders and managers, or principals and agents respectively. When conflict abounds, recognizing forces that trigger escalation and de-escalation of conflict is vital. We refer to a framework proposed by Bartos & Wehr (2008) that portrays forces responsible for escalation, and de-escalation of conflict. We identify similar forces within the context of shareholder activism, and assert that key actors should be familiar with those igniters and diffusers of conflict.

Introduction

Shareholder activism is a conflict-ridden construct that reflects ingrained tensions between shareholders and firm managers. Such tensions stem from perceived power imbalance, information asymmetry, and incompatible goals as suggested by agency theory.

Goranova & Ryan (2014) provide a broad definition of shareholder activism that we find appealing given its applicability. The term refers to "actions taken by shareholders with the explicit intention of influencing corporations' policies and practices, rather than as latent intentions implicit in ownership stakes or trading behavior." This working definition points explicitly at shareholder activists' pursuit of influence over firm policies and market strategy. Activists exercise their power and influence by either leveraging their equity position as investors - a stake gained through share accumulation, or by filing shareholder resolutions, or by threatening boards with a proxy fight during annual meetings.

Power plays a major role in conflict escalation and de-escalation (Bartos & Wehr, 2008), and an essential role within the shareholder activism discourse. The perception of power imbalance between shareholders and managers attracts conflicting views. For instance, while proponents argue for the strengthening of shareholders and call for stronger managerial accountability to shareholders (Dimitrov & Jain, 2011), opponents warn against regulatory changes that further empower shareholders as this may lead to an imbalance in a way that substitutes managerial self-serving with shareholder self-serving (Lan & Heracleous, 2010). However, power is but one driver of friction and tension between shareholders and firms. No less critical is the diversity of classes within the shareholder camp itself where groups are guided by their own interests and motives, thus increasing the likelihood of conflict between different streams of activism. Gillan & Starks (2007), for one, argue that financial and social activism appear to collide given that social goals may be considered secondary, at best, by financially driven shareholders. On the other hand, pursuing financial returns is seen by social activists as too exclusive and serving stockholders at the expense of other groups of stakeholders.

Yet, group heterogeneity is an attribute shared by actors from both the shareholder and the firm camps. These camps appear to be less homogeneous in their actions and reactions toward each other. The plurality of actors with self-serving interests and divergent motives constitutes a fertile ground for conflict.

Research on activism processes is scarce despite the wide range of actions available to both managers and activists. Furthermore, most empirical modeling of firms treats them as stationary targets rather than proactive entities attempting to engage their environs (Goranova & Ryan, 2014). This paper focuses on the conflict-rich interactions between firm managers and shareholder activists. Dynamic in nature and evolving, conflicts tend to escalate or de-escalate following action-reaction sequences that lead to new power arrangements, and ultimately to settlements involving compromise between conflicted parties.

We approach the nexus of relationships amongst key actors from several perspectives. The first two perspectives focus on shareholder-specific, and firm-specific dimensions respectively. These perspectives capture common typologies of shareholders and firms, highlighting the heterogeneity of motives and interests, and the action-reaction dynamics that characterizes relationships between these actors. A third perspective focuses on the proxy advisory industry, its rampant conflicts of interest and impact on both shareholders and managers. A fourth perspective focuses on agency theory and its assumptions relative to the divergence of interests of shareholders as principals, and of managers as agents. We view agency theory as a linchpin that bonds together both firm and shareholder domains. While previous domains deal with the inherent inter-intra-conflicts that characterize the nexus of contracts and relationships amongst key actors, the fifth perspective focuses on drivers of conflict escalation and de-escalation as they relate to shareholder activism, and on the repertoire of strategies firms use to manage conflict with activists.

Taken together, these five-perspectives help form a conceptual model that rests on a rigorous review of the literature – as our methodology of choice. It is further supported by examples of concrete cases involving firms and activists that are considered relevant to various sections of this paper. This two-pronged approach links theory with reality and provides for a richer context within which we develop our key arguments. Figure 1 depicts the various dimensions that this paper proposes to explore. Actors in this model form a dynamic network of relationships as they attempt to influence each other and reconcile, albeit temporarily, their incompatible goals.

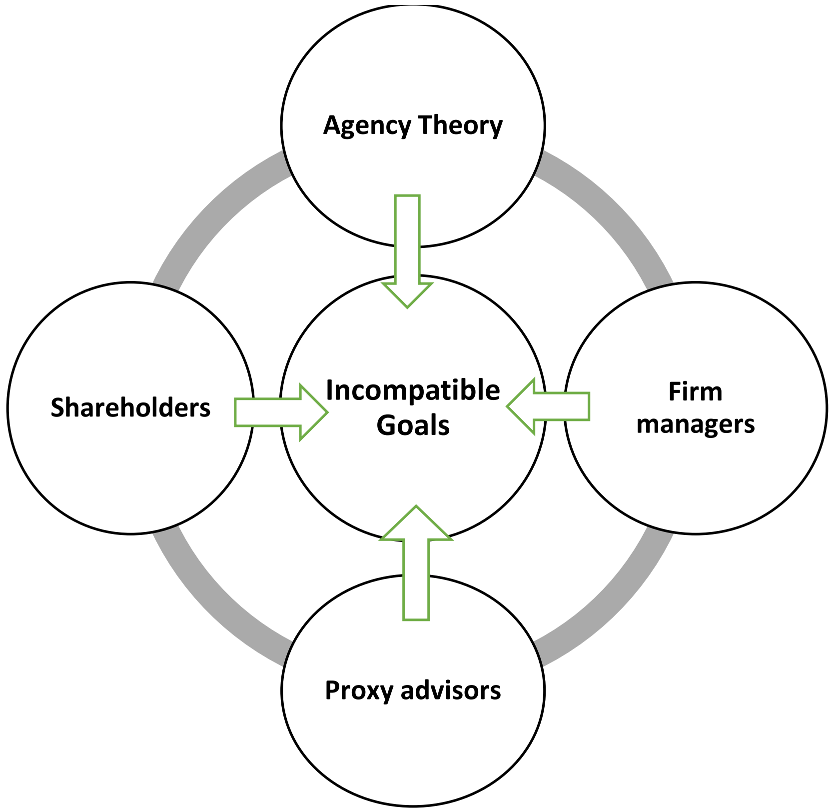

Figure 1: Shareholder Activism: Key Actors

The Shareholder Domain

Shareholders occupy the first dimension in our model. The multitude of shareholder investors with diverse motives, interests and modus operandi is a breeding ground for potential group conflict. Establishing shareholder profiles is thus warranted and serves several purposes. A shareholder typology helps define key actors, highlights their unique focus, singles out triggers of shareholder-related conflict, and helps classify each actor's actions and responses vis-à-vis firms and each other. The emerging picture suggests a plurality of actors with potentially conflicting interests and differentiated modes of operation.

Shareholder typologies

Several works attempted to develop classifications capable of distinguishing amongst various categories of shareholder activism. Gilson & Gordon (2013) propose a dichotomous classification of shareholder activism that is based on the degree of activism manifested by each class of investors. On one end are passive institutional investors that specialize in portfolio management, and who have little appetite for an active governance role. Pension and mutual funds are typical actors within this class of investors. On the other end are active shareholder investors that specialize in monitoring of firms' strategy and performance. Equity and hedge funds are representatives of the latter class.

The apparent gap between active and passive classes of investors, in terms of focus and interests, affects their relationships with firms and with other shareholder groups. For one, passive institutional investors present a critical challenge to shareholders given their preference for exiting underperforming firms rather than leveraging their shareholders' rights and engaging firms with the task of a governance change. The focus and actions of this class of shareholders are far from being firm-specific due to the logic of portfolio theory that calls for diversification across industries. Dropping a single stock of an underperforming company, in a multi-firm portfolio, is less demanding and less taxing than the investment needed for engaging firms' managers and influencing firms' strategy. The evidence suggests that the passive posture characteristic of power-concentrated intermediary shareholder institutions, like mutual funds, is indeed problematic given that it leads to undervaluation of shareholder governance rights (Gilson & Gordon, 2013). Gilson & Gordon point out that during the 2007-2009 proxy seasons, mutual funds only proposed eighty-four proposals, or less than five percent of all shareholder proposals. Furthermore, eight out of ten proposals were devoted to social and environmental issues, and only two out of ten dealt with corporate governance or firm performance.

While the passivity of institutional investors may lead to a governance gap, it also creates opportunities for a new breed of active actors who possess both the posture and skills that are suited for governance intervention. One such actor is the hedge fund who accomplishes intervention goals by acquiring a position in an underperforming company, by pressing for board representation, and by presenting a blue print for change. A typical hedge fund engages boards and tends to resolve potential conflicts behind closed doors using dialogue as a preferred form of negotiation (Nili, 2014).

Rose & Sharfman (2015) propose another typology of shareholder activism - offensive shareholder activism versus corporate governance activism. Under the umbrella of corporate governance activism are labor unions that actively seek changes in public companies' governance arrangements, executive pay, and social policy. Hedge funds are considered offensive activists since they seek radical changes in firm strategy leading to stock price appreciation and abnormal returns.

Rose & Sharfman (2015) argue that offensive shareholder activism fulfills a vital corrective function that reduces errors in a firm's decision making. Such reduction in errors is achieved through the transfer of exclusive information from the activist to the board of directors. Offensive activists may possess superior external information about competitors that surpasses the internal informational advantage of firm managers and board members (Rose & Sharfman, 2015). Thus, while activists and firm managers may have divergent and conflicting interests, they can still cooperate and play a complementary role engaging in beneficial exchanges of information and ideas.

Unions, on the other hand, are more likely to resist managerial self-serving behavior as they have less social capital at risk compared with other institutional investors (Schwab & Thomas, 1998). Thus, unions and pension funds may find themselves in conflict and at odds with C-suite managers given their role as suppressors of potentially opportunistic behavior of the firm's top echelon. Prevost, Rao & Williams (2012) point at another source of intra-conflict that involves unions and affects their role as a shareholder activist. Their activist role suffers from an inherent conflict of interest stemming from a dual role as a collective bargaining party, and as an agent of their members' pension funds. On one hand, they seek to increase workplace benefits to their union members, and at the same time also seeking to maximize shareholder value derived from pension plans under their direct management and oversight.

Still, a third typology is proposed by Nili (2014). Rather than adopting a simplistic dichotomous view of activism, Nili offers a differentiated taxonomy portraying the plurality of shareholder motives along with activist type, external considerations and unique mode of operation. His taxonomy highlights the complexity and versatility inherent in this multifaceted construct, and the probable friction and tension between one or more classes of shareholder activists.

Highlighting activist investors' diversity, Nili (2014) assesses four common models of shareholder activism -hedge funds, equity funds, traditional financial institutions, and social activists – along with their unique modus operandi. Consider the variation in motives that they share and the differing agency concerns that each class seeks to mitigate. Hedge funds are driven by a desire to maximize shareholder returns. Consequently, they build a stake in a target firm, and seek strategic changes aimed at managers and firm underperformance. Private equity funds are likewise motivated by financial performance and economic interests, but they seek to privatize publicly traded firms through a buyout, bringing along new managers for restructuring of these firms. Dell Inc. is a good example of a publicly traded company gone private via a buyout during 2013. Silver Lake Partners, a leading equity fund, was a major driving force behind Dell's buyout.

Contrary to both hedge and equity funds, traditional financial institutions (i.e. pension funds), argues Nili, are guided by political considerations rather than by pure economic interests, and show little interest in firms' governance issues. As to social activists, they seek to place shareholder resolutions on firms' ballots, and tend to use the media for publicity. This activist employs a hybrid model of activism combining internal and external campaigns for garnering maximum pressure (Nili, 2014).

In sum, whether dichotomous categories or a taxonomy of classes, leading actors – hedge funds, equity funds, labor unions and pension funds - play either a passive/defensive role, or an active/offensive role as investors, and are driven by either economic considerations, or political interests. Ultimately, the heterogeneity of roles also affects the actors' preferred mode of operation vis-à-vis target firms.

Shareholder action-reaction

Given the multitude of shareholder actors, one can assume a diversity of actions when facing target firms. Cziraki, Renneboog & Szilagyi (2010) assess shareholder activism through the process of proxy proposals, and explore the degree of investor homogeneity by their voting. Their findings support the notion that shareholder voting pattern indicates a high degree of fragmentation within investor groups rather than a unified homogenous front. It appeared that some shareholder groups such as insurance companies, banks and trust companies are less likely to support shareholder proposals. These shareholder investors are pressure-sensitive given their ongoing relationships with the companies they invest in, thus presenting them with increased risk of conflicted voting (Cremers & Romano, 2007).

Shareholder reactions, as a whole, reflect dissatisfaction with firm's governance and performance (Gillan & Starks, 2007). Shareholders can adopt a trade response by pursuing an exit strategy (i.e. sell of shares), or a more active strategy that seeks radical change in ownership control (i.e. a buyout or a takeover). Between these two extremes, lies a third possible reaction – a voice strategy that may be pursued by shareholder activists. Voice can be private and informal (i.e. covert dialogue and negotiation), or public and formal (i.e. lawsuits and litigation) (Armour, 2008). Applying Nili's class taxonomy to shareholder action-reaction dynamics, it may well be that institutional activists are likely to pursue a passive trade strategy, private equity funds are more likely to pursue radical change in corporate control, and hedge funds activists prefer to pursue a voice strategy.

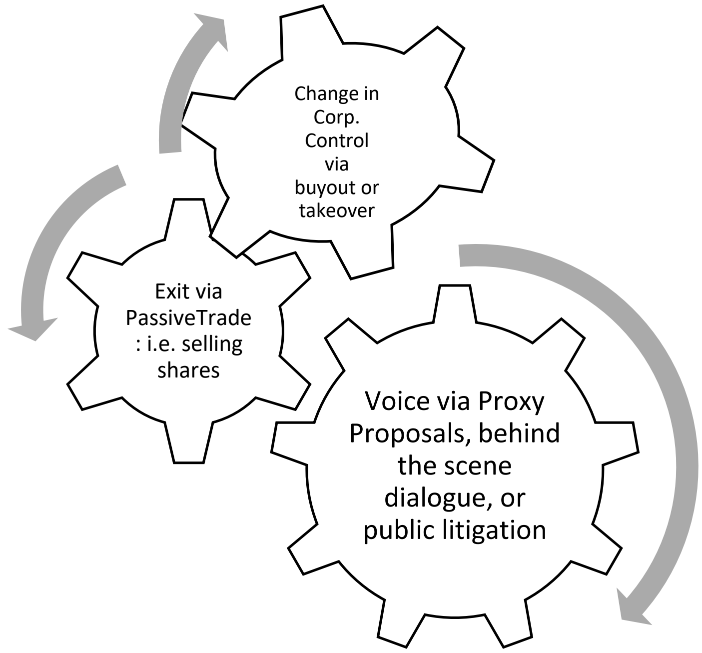

Figure 2: Shareholder activism: Activist responses.

Figure 2, depicts possible activist responses. Exit and change in corporate control reflect unique reactions that move in different directions. Their illustrated small size suggests that they attract less attention, and are perceived to be less useful in resolving the agency dilemma compared with a voice strategy (Cziraki, Renneboog & Szilagyi, 2010). Voice is more dominant and meaningful as a strategy given that shareholder activism seeks a change within the firm without a change in control or an exit (Cziraki, Renneboog & Szilagyi, 2010). Shareholder activism that is manifested through voice (i.e. dialogue, negotiation, proxy proposals) is a useful strategy for mitigating the agency problem (Bebchuk, 2005; Harris & Raviv, 2008).

The Firm Domain

The firm occupies the second dimension in our model. Diversity cuts across shareholder classes as well as across firms, making the latter far from being a homogenous group. Firm heterogeneity can be manifested in the ways managers perceive and react to shareholder activism. Attempting to understand managers' reactions to activist actions is essential given the possible link between firm-specific internal characteristics and firms repertoire of responses. Theodore, Navis & Fisher's (2013) advance a framework that identifies primary reactions to shareholder actions, and argue that firm action-reaction cycle emanates from its organizational culture and from firm-specific internal beliefs about obligations to external stakeholders.

A Firm Typology

Viewing firm culture as a continuum that ranges from corporate egoist to corporate moralist (Jones, Felps & Bigley, 2007), Theodore, Navis & Fisher propose that managers of firms that tilt toward the egoist end, tend to view external stakeholders as a prime constituent that leads them to seek wealth maximization. Managers of such firms are primarily guided by economic considerations, and will only support social responsibility practices if they add economic value to the firm. Managers of firms that lean toward the moralist end, tend to consider the broader interests of society and seek operational integrity over short-term wealth maximization, thus viewing social responsibility as an ethical imperative. Consequently, egoist culture views activist actions in terms of economic threats, while moralistic culture views activist actions in terms of identity threats (Theodore, Navis & Fisher, 2013).

Whether moralist or egoist, organizational culture can be an inhibitor of conflict with shareholder activists, and the nature of a perceived threat may dictate the manner in which managers' view and respond to activism. Consider that identity threats may lead to a change in firm practices given the public discourse that respective activists engage in, and the potential for reputation damage. Similarly, the perceptions of economic threat and financial harm from activists' campaigns are but one reason that compels managers to adopt changes to the firm's contested practices. In fact, perceived economic threats may explain the success of hedge fund activists, and the willingness of managers to engage with them.

Xerox is a case in point. Xerox has been struggling for a long time despite management attempts to reverse course. The firm tried to transition into a services-based business that would handle back-office operations for government and other firms but success never followed. Late in 2015, Carl Icahn, an activist hedge fund manager, disclosed an accumulation of 7.1 percent stake in Xerox declaring that the firm is undervalued and his intent to seek board representation. Xerox response was quick stating that it welcomes open and constructive dialogue with shareholders, and its intent to undertake a comprehensive review of structural options in light of recurring revenue deterioration (Beckerman, 2015).

Firm Responses

Managers' behavior ranges from a favorable interaction and dialogue with shareholders on one end, to dismissal and derailing of activists' concerns and demands on the other end (Proffitt & Spicer, 2006). Generally speaking, the continuum of managers' behaviors toward shareholder activism involves three specific actions - *reacting-interacting-proacting* – with each behavior being manifested through different set of actions. Reaction may be reflected in managers' ingratiatory behavior and in persuasion of activists as a way to delay implementation of changes rather than derail shareholders' demands. Interaction involves approaching activists with the intent to adopt and implement their suggestions and solicit approval, thus preempting shareholder coalition building and proxy fights. Proaction manifests itself in managers monitoring of activism at other peer firms and assessing its success level before developing measures of their own (Ferri & Sandino, 2009).

Within Theodore, Navis & Fisher's (2013) framework, approaching a firm action-reaction from the prism of the egoist-moralist typology suggests that the firm's organizational culture elicits similar reactions to shareholder activism. Specifically, managers' reactions to activist campaigns range on a continuum from resistance to accommodation (Oliver, 1991; Zald, Morrill

& Rao, 2005). The former involves overt denial of activists' arguments, the latter seeks to nullify activists' threats by adjusting practices to satisfy external demands. Figure 3 depicts key arguments made by Theodore, Navis & Fisher (2013), and captures the dynamics of the firm's cultural orientation and its reaction to perceived shareholder threats.

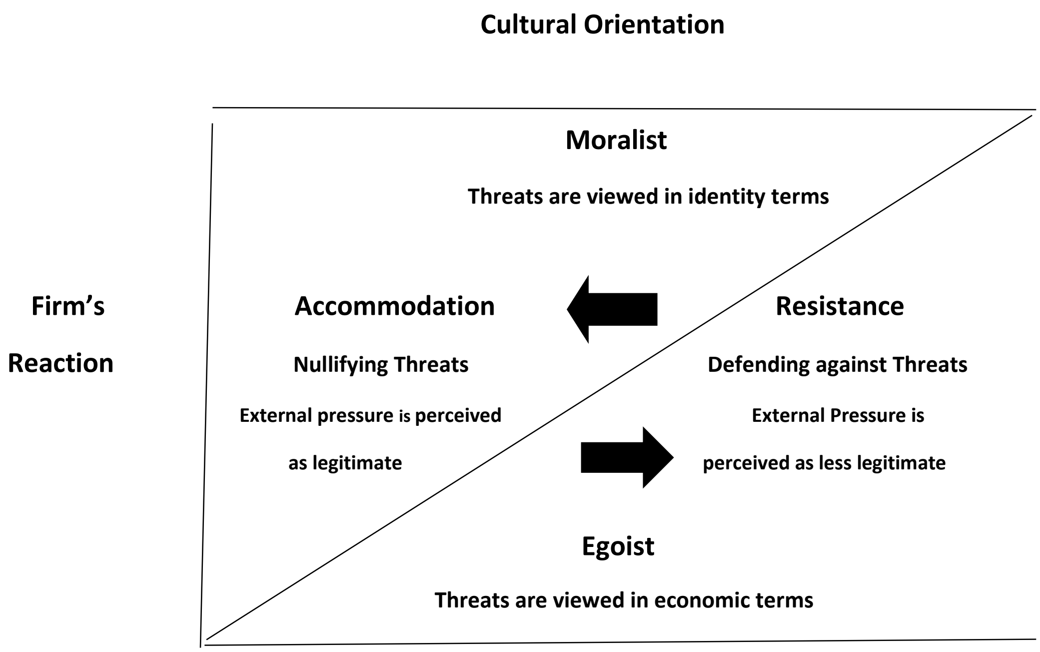

Figure 3: Shareholder Activism and Firm's Reaction

Empirical evidence suggests that external pressure that is perceived as coherent and legitimate encourages the firm to seek accommodation, while a less legitimate and less coherent pressure increases firm's resistance (Oliver, 1991). Accommodation can be expressed in the form of a symbolic action that involves promises for a change of practices that may, or may not be implemented. However, accommodation may also involve substantive changes that meet shareholder activists' demands (Fiss & Zajac, 2006). Recent developments at two large firms support the latter argument. Two leading activists – Trian Fund Management and Elliott Management – have been supportive of management that changed course at GE and Alcoa respectively. Elliott Management Corporation. disclosed in late 2015 that it built a 6.4 percent stake in Alcoa after the company announced its decision to split in two – a parts-making business and a raw-aluminum operation. The hedge fund's disclosure signals its support and endorsement of the split decision and its positive assessment of a continued improvement in Alcoa's margins in months to come. Similarly, Trian Fund Management disclosed its $2.5 billion stake in GE arguing that its massive investment is a stamp of approval that followed GE decision in late 2015 to exit its financial business and narrow its focus. It appears that both firms considered favorably shareholders' ideas and input (Benoit, 2015b).

Within the context of the Theodore, Navis & Fisher (2013) framework, we assume that hedge funds and equity funds are likely to face initial resistance given their perceived economic threats to opportunistic firm managers. Firm managers are likely to view these activists' motives as less legitimate thus triggering a defensive reaction by target firms. Unions and public pension funds are likely to face some degree of accommodation by firm managers given their social stand, and given that they are likely to be perceived as less threatening to socially leaning firm managers, and/or as actors whose threats can be managed and nullified.

As a whole, firms concerned with their social and financial risks (i.e. leaning toward a moralist and/or egoist orientations) will have more incentives to develop relationships with shareholder activists, and especially with powerful activists who pursue issues that appear salient for the firm as well as society at large. Indeed, dependency theory suggests that there are incentives for a firm in establishing linkages with external actors (Rehbein, Logsdon & Van Buren, 2013). Empirical findings further suggest that firms that pursue relationships with key stakeholders may enjoy reduced risks and added value given that the latter possess resources that are critical to firm success (Mirvis & Googins, 2006).

The Proxy Advisor Domain

The proxy advisor domain occupies the third dimension in our model. The proxy advisory industry represents an interconnected network of constituents – firms, shareholders and institutional investors – that are served by the same proxy advisory firms. Such firms advise managers with their sponsored proposals, and at the same time also advise institutional investors with their own resolutions. As disturbing is the fact that the same proxy advisors also act as independent governance rating agencies assisting firms with ways to improve their ratings (Boatright, 2009; Hyatt, 2010). It is thus apparent that conflicts of interest are abound in the current proxy voting system (Clark & Van Burren III, 2012).

Further exacerbating the current state is the fact that the industry is dominated by a single actor - RiskMetrics/ISS - resulting in the 'shareholder democracy' movement being somewhat weakened. RiskMetrics/ISS advises a constituent base that equals about half the world's common stock (Hyatt, 2010), and it serves as an example of an advisor awash with conflicts of interest. This service firm offers both proxy advice to shareholders and institutional investors, and governance rating advice to corporations. Clark & Van Buren III (2012) argue that while it owes a fiduciary duty to its clients, the institutional investors, this duty is not extended to corporations and their shareholders. Absent such a fiduciary relationship, shareholders' monitoring ability is significantly reduced. Further harming fiduciary duty is the practice of firms who are being rated and who pay a service fee for the ratings, who also engage in lobbying the rater (Choi, Fisch & Kahan, 2010).

An additional complicating factor is the dispersion of share ownership and the enormous number of shares voted annually which makes investor voting by proxy statement more practical for both firms and their shareholders. A Security and Exchange Commission (SEC) regulatory change in 2003 (SEC, 2003) gave institutional investors the authority to vote client proxies. The SEC initial intent was that by using external proxy advisers, potential conflicts between fund managers and the companies in which they invest, can be alleviated. At the same time, conflicts at the advisory firms were ignored. These proxy advisors continue advising corporations on how to improve their governance ratings, and making such rating available to other constituents on behalf of those corporations (Stout, 2006).

Lawmakers and the U.S. Chamber of Commerce accused the two firms that dominate ninety-seven percent of the shareholder advisory industry, RiskMetrics/ISS Inc. and Glass Lewis and Co., of crafting activist proposals that involve issues in which they have financial interest. The SEC, likewise, has charged RiskMetrics/ISS in breach of clients' confidential proxy voting information (Hamilton, 2013). At the heart of such claims is the belief that proxy advisory firms increase the agency costs of doing business for many publicly traded firms, and worse – serious conflicts of interest permeate their activities given that they issue voting advice to shareholders about firms with whom they have business interests.

Dismantling the proxy advisory structure altogether may not be an option given the vital services this industry provides. Minimizing the negative effects of the industry's ills seems more plausible and is warranted. Clark & Van Buren III (2012) propose three organizational strategies for dealing with conflicts of interest. While each strategy provides some remedy, all three share some limitations. Advisors can disclaim any fiduciary responsibility, but if a fiduciary duty does exist, a disclaimer to the contrary is unethical; advisors can disclose a possible conflict, but admitting to a conflict of interest without attempting to cure it is likewise far from being ethically responsible; and, advisors can create an internal separation between parts of a firm that are involved with a conflict of interest, and other parts that are not. Yet, while structurally separated, internal processes may cross departmental boundaries thus affecting the separation (Clark & Van Buren III, 2012).

It appears that none of the proposed strategies is sufficient enough for dealing with conflicts of interest, and with the regulatory regime's unintended consequences. Thus, only a change in current regulation by the SEC carries a promise for improvement. A new proposed SEC guidance frees investment funds from the need to use proxy advisors for voting decisions in corporate elections (The Wall Street Journal, 2014. July 22). Time will tell just how effective is the regulatory regime's new guidance in reforming the proxy advisory industry.

Agency Theory: A Guiding Framework

Agency theory occupies the fourth dimension in our model. The theory postulates that incompatible goals between shareholders and managers are the root cause of tensions between both parties. When applied to corporate governance, agency theory portrays a dilemma that an absent owner, termed a principal, faces when contracting a manager to act on their behalf. The manager, as an agent, is likely to be an opportunistic and a self-interested entity thus serving their interests at the expense of the owner's. The divergence of goals necessitates monitoring of the agent's conduct by the principal who incurs related monitoring costs (Jensen & Meckling, 1976).

Practical in nature, agency theory proposes ways capable of mitigating the agency problem and its subsequent conflict. Specifically, the theory calls for the deployment of various external and internal mechanisms that include market driven governance mechanisms, board-based mechanisms, and internal incentives. Market governance mechanisms include financial disclosures, the market for corporate control, and the managerial labor market. These external mechanisms act as disciplinary means that safeguard against poor managerial performance. Board-based mechanisms add teeth to the monitoring system in place. The independence of the board of directors and the separation of board-chair and CEO positions are designed to ensure effective monitoring of managers given agency theory's assumptions relative to the opportunistic behavior of the agent.

Agency theory seeks likewise to resolve the agency problem by determining the most efficient internal mechanism governing the agent-principal relationship. Unobservable behavior by the agent requires the principal to invest in information systems that entail monitoring of agent conduct via financial reporting and board oversight (i.e. behavior-based contract). Yet, the principal can also employ an outcome-based contract seeking to motivate the agent via incentives thus shifting the risk to the agent (Eisenhardt, 1989). Both these governance mechanisms are aimed at limiting the agent's self-serving conduct by controlling the agent opportunism. Ultimately, the entire repertoire of actions proposed by agency theory is meant to align the agent's interests with those of the principal.

Competing Governance Theories

From a shareholder perspective, the board of directors fulfils an essential monitoring function. Agency theory highlights the primacy of the investor/shareholder and the critical policing role of the non-executive board of directors. Unlike agency theory's view of boards and the self-serving motives of firm's managers, competing governance theories approach firm governance from a different angle. For example, while agency theory considers the board of directors to be a guardian of shareholder interests by fulfilling a policing role on behalf of investors, resource dependence theory (Pfeffer & Salancik, 1978) sees the board of directors as a vital resource-base for improved firm performance. Experienced directors provide advice and counsel for strategy crafting and execution, and act as a source of contacts, information and relationships. And contrary to agency theory's pessimistic beliefs regarding the opportunistic and self-serving motives of managers, stewardship theory proposes that managers act as responsible stewards of the assets they control (Donaldson, 1991). It further argues that managers' motives and interests are aligned with those of shareholders as both seek the firm's long term viability. Finally, unlike agency theory's assumptions as to the primacy of shareholders, stakeholder theory argues that the firm should be managed in the interests of all stakeholders – investors, employees, suppliers, customers and the environment (Freeman, 1984).

Homogeneity vs. Heterogeneity of Shareholders

Within the context of shareholder activism, agency theory views the homogeneity of shareholder interests as a central premise since it enables the creation of a unified front vis-à-vis opportunistic managers (Jensen, 2001). Agency theory further suggests that stakeholder theory's support for heterogeneous groups makes it near impossible to represent and act on behalf of multiple constituents with conflicting goals (Sundaram & Inkpen, 2004). Interestingly, our discussion of actors within the shareholder domain portrays a plurality of shareholder groups with divergent motives and different modes of operations. Thus, a critical challenge arises given the heterogeneity of the shareholder camp. Nevertheless, a unified front can be established through shareholder alignment. This requires coalition building that coalesces around shared interests. Coalition building demands some level of solidarity being augmented with necessary resources. Resources are essential for mounting and sustaining activist campaigns, either in the open or behind closed doors. And, as critical, group solidarity and alignment call for effective leadership.

Hedge funds appear to possess those very same ingredients. The current clash between Yahoo's board and a coalition of 3 shareholders, headed by Starboard Value Fund, is but one example of an activist with effective leadership skills, a coalition builder with a unifying message and with sufficient resources to mount and sustain a credible proxy fight. Faced with such a solidified front, Yahoo's board is inclined to accommodate the activist with a significant number of board seats (The Wall Street Journal, 2016. March 25).

Finally, from an agent's perspective, and within the context of the agency dilemma, assessing managers' options for action is also warranted. Goranova & Ryan (2014) propose several realistic scenarios. Managers can resist and ignore legitimate value creating activism, thereby reinforcing the classic principal-agent dilemma, or yield to self-serving demands from influential activists that can lead to a principle-principle problem. This scenario results in the firm being subordinated to activists, and hence can endanger the firm viability. Alternatively, managers can act as corporate stewards by resisting self-serving value destroying activism, or by adopting value creating shareholder demands, thereby reinforcing the principal-agent alignment. The latter scenario aligns well with agency theory as a linchpin, bonding together firm managers and shareholders, and leading to firm protection and firm optimization for the benefit of both owners and agents.

In sum, agency theory is a dominant corporate governance approach that highlights tension inherent in transactions between firms and shareholders. Despite its pessimistic assumptions about human behavior, agency theory is a practical approach that seeks to resolve conflicts of interest of owners and their agents. Built-in incentives, monitoring mechanisms and disciplinary measures are part of the cost of doing business. Yet, they enable and sustain the link between actors and help moderate the power struggle between both parties. As such, agency theory helps bridge gaps between two conflicted parties while serving as a linchpin between actors in need of each other – an absent owner and a contracted agent.

Shareholder Activism: Conflict Dynamics

The discussion of the fifth dimension in our model moves beyond the conflict between shareholders and firm managers, focusing instead on triggers that fuel conflict escalation, and contributors to de-escalation. We adopt a framework advanced by Bartos & Wehr (2008) that appears relevant to our topic given that it portrays conflict as a dynamic force that is amenable and that can be tamed for the benefit of the parties involved.

A Working Definition

Bartos & Wehr (2008) provide a working definition of conflict that points to incompatible goals as a key driver. We find incompatible goals to be particularly applicable to shareholder activism in light of the heterogeneous nature of actors with divergent motives and interests. Bartos & Wehr define conflict as a "situation that involves actors using conflict behavior against each other to attain incompatible goals and/or to express their hostility." (p. 13). Bartos & Wehr (2008) propose three possible causes of goal incompatibility: contested resources due to a sense of a deficit; incompatible roles due to the division between those who tend to protect the interests of the 'whole' versus those who protect the interests of the 'part;' and finally, incompatible values that bonds a group together due to a separation between groups and/or organizations.

We contend that all three causes of goal incompatibility hold true in the case of shareholder activism. First, agency theory emphasizes the need for alignment of shareholders' interests around shared values that potentially bond investors together against managers' opportunistic behavior. Self-serving behavior seeks to serve the interest of the 'part' at the expense of the 'whole,' thus reflecting an incompatible value system. Second, as to contested resources, shareholder investments in a firm and the desire to unlock further value is essential. Firm underperformance equates with low returns and reinforces a sense of deficit and deprivation of potential profit. Deficit spurs activist demands for a role to play via shareholder resolutions and through share accumulation. The perceptions of information asymmetry and power imbalance are likewise deficits that fuel activists' attempts to gain representation in the boardroom. Third, agency theory suggests role differentiation between shareholders as owners/principles and managers as agents. Role differentiation contributes to the divergence of interests that is likely to exist between these parties.

Bartos & Wehr's (2008) definition leads us to conclude that conflict between managers and shareholders is inevitable since it rests at the heart of their incompatible goals. Wehr, Burgess & Burgess (1994) suggested that as conflict emerges, a party in the conflict can use one or more options: it can use coercion and apply force or voice threats of using force; it can move to negotiation and offer rewards and benefits for cooperation; or, it can use persuasion as the means to reach an accommodation and a mutually agreed-on settlement.

Within the context of shareholder activism, activists threaten proxy fights when firms reject their demands, or ignores them altogether. Hedge funds, in particular, prefer using dialogue and persuasion behind closed doors first, but tend to go public when dialogue and persuasion fail. Yet, it appears that in many instances, activists are accommodated by corporate boards and are rewarded seats at the table as a constructive way to defuse conflict. In other instances, the rejection of activist demands is sufficient to trigger an unfavorable reaction that unless quickly defused may turn into an escalating conflict. As other shareholder investors become aware of their incompatible goals, they align their interests with other shareholders, develop a group solidarity, and engage in free interaction that favor a conflict action.

A Case Application

The case of Tempur Sealy International, a mattress maker, and H Partners Management, an activist hedge fund, illustrates how rejection of activist's demands coupled with the nature of the personalities involved play an active role in the escalation of a conflict. H Partners is Tempur Sealy's largest shareholder with ten percent stake in the firm. In early 2015, the fund issued an ultimatum to the manufacturer demanding the immediate resignation of three key players - the board's chair, the company CEO, and one board director – all within six days, or else the fund would go public with its views as to the company being long mismanaged. Such demands reflected shareholders brewing frustration with the firm's weak performance and weak stock price three years in a row. With no response from the mattress maker, H Partners made the dispute public. Following a missed earning forecast, it was able to build a coalition with the majority of shareholders and oppose the re-election of the three targeted individuals just to be replaced by two of the fund's nominees. H Partners' victory illustrates the danger of underestimating activist investors regardless of their size. Moreover, communications between the chairman and the fund suggest how quickly personal relationships can deteriorate resulting in escalation of conflict between key actors from both parties. Ignoring requests for meetings and dialogue can be interpreted as dismissive gestures that carry a price tag both financial and otherwise (Hagerty, 2015).

Conflict Escalation and De-escalation

Bartos & Wehr (2008) point at triggers that fuel conflict escalation. A unilateral escalation will originate within one party, and a reciprocal escalation originate within the other party. The former may stem from feelings of deprivation, from a sense of asymmetric or overwhelming power, or simply because of a conflict prone personality. The latter force, if relatively weak, may trigger retaliation, or else it can lead to submission of the other party if overwhelming in nature. Figure 4 depicts forces and related dynamics during conflict escalation.

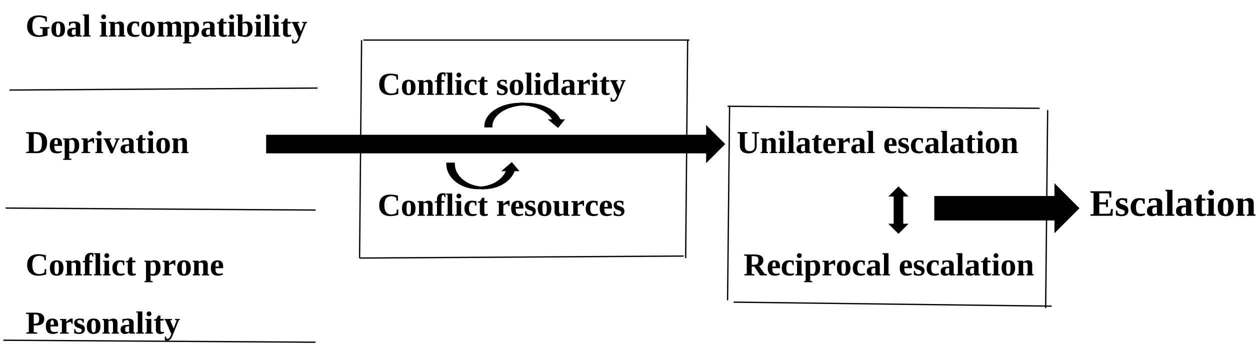

Figure 4: Conflict Escalation: Drivers and Dynamics (Source: Bartos & Wehr, 2008).

The clash between H Partners Management fund and Tempur Sealy International contained many of the ingredients that fuel conflict escalation as depicted in Figure 4. Goal incompatibility between the parties coupled with a sense of unfulfilled returns (i.e. deprivation) due to mismanagement, and feelings of animosity and lack of trust between the fund and the board and CEO (i.e. personalities) brought the conflict into the open. Once in public, a coalition of shareholders coalesced around shared interests (i.e. conflict solidarity), and led by an activist with a clear message it issued an ultimatum to the firm (i.e. unilateral escalation). H Partners Management had the upper hand. Rather than a retaliation, the board succumbed to shareholders' demands (i.e. no reciprocal escalation).

Bartos & Wehr (2008) further suggest that in instances of a stalemate or a prolonged conflict, a unilaterally escalating party is bound to reverse course and commence a unilateral de-escalation due to feedback from its opponent, or due to changing conditions that affect members' conflict solidarity, or simply because of its inability to sustain the conflict due to depleted resources. When applied to shareholder activism, the case of Darden Restaurants Inc. is one example of a firm adopting a de-escalation action after a long standing conflict with a key activist.

Darden Restaurants, the owner of Olive Garden, Red Lobster, Capital Grille, and Long Horn Steakhouse has been in a lengthy conflict with several investors, including Starboard Value and Barington Capital, who argue that value can be unlocked with a breakup into three businesses. Instead, the board elected to sell Red Lobster contrary to the investors' demands, thus upsetting shareholders. The board move brought the conflict into the open, thus making the activists' position known to other shareholders and inadvertently helping unify the investors' front against the board. Fearing reputation damage and a lingering stalemate, the board signaled by mid-2014 a willingness to de-escalate the conflict. Faced with criticism from both Starboard, and Barington Capital, with eight, and two percent stake in Darden respectively, the board announced that the CEO, who also served as chairman, was stepping down. The board responded to the request for a split of both roles and opened up the board to Starboard's three nominees (Benoit & Jargon, 2014).

The case of Darden Restaurants illustrates the tradeoffs associated with a party's response to escalating conflict. De-escalation involved power-sharing with activists via board representation in return for industrial peace. As critical are the strategies utilized for managing open conflict with shareholder activists.

Conflict Management Strategies

Firms use a host of conflict management strategies when facing activists. The repertoire used includes avoidance, cooperation, accommodation and competition. While these approaches appear independent from one another, they are also fluid and situational enough to allow firms to employ more than one as circumstances develop. A few examples detail these four conflict management strategies and their respective impact.

Avoidance. Yahoo's past treatment of Third Point Management, a shareholder activist, reflected an erroneous approach for dealing with activists, believing that by ignoring them their demands would go away. The activist fund built a stake in Yahoo in 2011 and was repeatedly dismissed and ignored by Yahoo's board and its chairman. By mid-2013, Third Point Management joined the company's board and gained enough influence to vote the dismissive chairman out of office (Gelles, 2013). The Yahoo case suggests that *avoidance* as a strategy appears ineffective and costly and is likely to backfire.

A different strategy involves *cooperation*. This strategy involves a dialogue with the activist coupled with enhanced investor outreach that follows a self-assessment of the firm's perceived vulnerabilities. Such a self-study appears necessary given that fund activists are seasoned analysts and financial engineers equipped with white papers about the firm performance and growth potential. Cooperation with fund activists involves open communication and dialogue and tends to be out of the public eye. An example of cooperation with an activist took place in 2015 during the merger talks involving Dow Chemicals and DuPont and an activist who helped orchestrate the deal. Activist investor Nelson Peltz was a key player and a critical facilitator during the discussions between the companies' CEOs that led to the merger deal. Seeking input and cooperation with the activist, Dow and DuPont CEOs engaged Mr. Peltz in the process. Peltz, on his part, worked behind closed doors with both CEOs and was instrumental in planning and executing the deal, thus ushering in a new high for shareholder activism (Benoit, 2015a).

Accommodation is an additional strategy whereby a targeted firm attempts to bring activists into the fold by promptly meeting their demands and thus defusing a potential conflict before it becomes public. An example for this approach is the case of ValueAct Capital fund and Microsoft. Despite a small stake of less than one percent, the fund was welcomed into the board of Microsoft in early 2014 with the promise of not boosting its stake in Microsoft to 5 percent and for not engaging in a proxy contest (Reuters, 2013. July 20). In return, Microsoft vowed to work with the hedge fund and gave it a board seat.

A different strategy for managing a potential conflict with activists is *competition* – that involves adopting a competitive posture, and the use of aggressive and defensive moves such as poison pills and staggered boards. However, clashing with an activist head -on is of little use given the public attention it garners and the potential for a costly reputational damage. An example for the use of this strategy is the case of Jana Partners and Safeway, the supermarket chain. Jana Partners, a hedge fund, disclosed in early 2014 a five percent stake in Safeway, and its intent to increase its stake and press for divestitures and shareholder returns. Safeway responded with an aggressive and a defensive move by adopting a new shareholder rights' plan that established that no investor filing a 13-D form (i.e. a designation of a party as activist) could acquire more than ten percent of company's shares (Gelles, 2013). Given that rarely do hedge fund activists acquire targeted firms, such strategy carries little merit. Table 1 captures key ideas contained in our model's five domains.

Table 1: Consolidated Model's Ideas.

Actor	Key Attribute	Key Argument	Conflict Focus	Theory/Framework	Action
Shareholders	Plurality of classes, motives, and interests; market disrupter.	Primacy of shareholders/ and stockholders.	Shareholder alignment vs. self-served opportunistic managers.	Agency theory (Jensen & Meckling, 1976).	Exit; radical change; voice.
Firms	Diverse group with multiple goals and interests; market continuity	Primacy of board; director primacy; status quo seekers.	External pressure coherent/legitimate vs. less coherent and illegitimate.	Corporate moralist-egoist continuum (Jones, Felps & Bigley, 2007).	Resistance; accommodation; dialogue
Proxy Advisors	2 dominant players; advising firms, shareholders and institutional investors simultaneously.	The industry empowers one player at the expense of shareholders; increasing agency cost.	Rampant conflicts of interests; broken fiduciary line.	A framework for managing conflicts of interest (Clark & Van Buren III (2012).	Governance rating agency; issue voting advice to shareholders about firms with whom they have business interests.
Agency Theory	Governance theory with pessimistic view of human behavior; linking-pin; practical	Agency dilemma; mechanisms designed to align agent and principal interests do work.	Goal and interest divergence between owner/principal and manager as agent.	Agency theory (Jensen & Meckling, 1976).	Consider both behavior-based contract and outcome-based contract
Conflict - Dynamics	Framework captures conflict igniters and diffusers;	Incompatible goals at core of conflict; applicable to shareholder activism.	Contested resources; value and role incompatibility.	A framework by Bartos & Wehr (2008).	Escalating conflict can be de-escalated; conflict is manageable.

Discussion and Conclusions

Shareholder activism is a conflict-rich construct given the heterogeneity of the actors involved and the divergence of interests between firm managers and shareholder investors. Pointing at goal incompatibility as a driver, we believe that agency theory provides a context for understanding the inherent friction between key actors on the opposite ends of the table – shareholders and managers, or principals and agents respectively. Proxy advisors, an exogenous actor that interact with both shareholders and firms, suffer from rampant conflicts of interests that affect negatively investors and beneficiaries alike. Recognizing forces that trigger escalation of conflict, and contributors to de-escalation of conflict is vital. We referred to a framework proposed by Bartos & Wehr (2008) that portrays with great clarity forces responsible for escalation, and de-escalation of conflict, and sought to identify similar forces within the context of shareholder activism.

The thrust of this paper leads us to four specific conclusions that are worth mentioning. First, the plurality of shareholder classes with diverse motives and modus operandi presents a challenge when considering the formation of a unified front vis-à-vis empowered managers and boards. As such, shareholder heterogeneity aligns well with stakeholder theory, but stands contrary to agency theory's central premise. Coalition building within the shareholder camp that coalesces around shared interests becomes necessary and essential. Hedge funds appear to fulfill this role well and are best suited to continue in this vain.

Second, boards have little chance to withstand shareholders when facing a resolute activist who presses for change. This holds true particularly in cases involving hedge fund activists, given the significant stake they build in a target firm, the resources they muster for a long campaign or a proxy fight, and the impact their blueprint carries in terms of interest and support from other shareholder groups. As frequent stories in the media suggest, firms will accommodate activists' demands sooner than later.

Third, it appears that the current proxy advisory industry empowers one proxy firm at the expense of shareholders. The conflicts of interest within the proxy advisory industry underscore the need for immediate remedy. The consolidation of services in the hands of one or two actors hurts shareholder interests and harms beneficiaries. Heterogeneity in this industry in the form of more competition should be encouraged as a means for the reversal of the elevated degree of centralization within the current system.

Fourth, when considering the plethora of firms' responses to shareholder activism, dialogue emerges as a promising strategy. The evidence suggests that dialogue is an optimal option for both parties (Rehbein, Logsdon & Van Buren, 2013). Dialogue reduces shareholder resolutions thus reducing conflict flare-ups. Dialogue reduces external uncertainty, shifts the parties' attention and visibility from the public eye to a private forum, and helps minimize the prospects of a stockholder's coalition building (Rehbein, Logsdon & Van Buren, 2013).

In closing, shareholder activism is fast growing into a movement that can no longer be ignored by corporate boards as it is altering the balance of power between firm owners and managers. Shareholder activists hold corporate managers accountable to their companies' shareholders and stakeholders, and pressure them to remedy managerial deficiencies. In this role, shareholder activism is a marketplace disrupter targeting entrenched managers and threatening the status quo that firms seek to preserve.

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