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Activism, Whole Foods, Etsy and benefit corporations

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Shareholder activism is everywhere. In May, hedge fund Jana Partners pushed Whole Foods Market to overhaul its board, fix its operations and pursue "all avenues to shareholder value creation," following a slump in its share price and stiff competition from other grocers entering the organic food market.[1]

Etsy, a path-breaking online marketplace, laid off nearly a quarter of its employees this spring and hired a new chief executive officer in May after shareholder complaints of weak growth.[2]

As often happens in these situations, the shareholder pressure led Whole Foods to sell itself in June to the highest bidder, Amazon, as the premium that accompanies a sale is almost always a sure bet to boost a company's share price in the short term.[3]

It wasn't always this way. It used to be that when shareholders didn't like a company, they sold their shares and moved on. They did not write letters or conduct proxy contests. But investors have spent decades fighting for a stronger hand in corporate governance.

Shareholders now have power to negotiate for change, and this has led to an explosion in campaigns that push companies to increase their current share price, even if it means selling the company, and even if it means laying off loyal workers who created the value being harvested.

It wasn't always this way. It used to be that when shareholders didn't like a company, they sold their shares and moved on.

After a fierce campaign with activist shareholders, the venerable DuPont Co., which is known for products like Teflon and Nylon, announced December 2015 that it would merge with Dow Chemical Co., and it laid off hundreds of scientists weeks after the announcement.[4]

The lead article in the May-June 2017 issue of the Harvard Business Review, written by Harvard Business School professors Joseph Bower and Lynn Paine, addresses this power dynamic issue by challenging the idea of shareholder primacy, which is the concept that corporations should be run for the primary benefit of shareholders.

In particular, the authors question the benefits of shareholder activism that pursues immediate profit at the expense of other important values.

"Budget cuts that eliminate exploratory research aimed at addressing some of society's most vexing challenges may enhance current earnings but at a cost to society as well as to the company's prospects for the future," the article says.[5]

What if companies save costs by reducing employee pay so their workers must use food stamps, or save costs by increasing harmful outputs that burden community health? The article notes that corporate "cost-saving" often just shifts near-term costs from a business to everyone else.

"It appears self-evident that shareholders' gains are sometimes simply transfers from the public purse," Bower and Paine say.

Nor is this mere wealth transfer — the real costs of these money saving measures, such as increased climate risk, inequality and decreased innovation, will impact investors in the aggregate much more than any potential incremental financial returns they would receive through corporate cost cutting.

The world's largest asset managers recognize the importance of adopting a long-term view. Larry Fink, chairman of BlackRock Inc., wrote a letter to CEOs this year that spoke of the need to shift "the tide of short-termism afflicting our society."[6]

Ron O'Hanley, chairman of State Street Global Advisors, recently described the firm's mission for clients as "invest[ing] responsibly on their behalf to enable economic prosperity and social progress over the long term."[7]

It is a mistake to identify shareholder activism itself as the problem — shareholder stewardship can be a critical check on management, and good corporate managers will work with investors to create real economic value.

The problem isn't activism; it's short termism — whether instigated by shareholders with short time horizons or by managers who "think like activists" (perhaps quickly inflating the value of their stock-based compensation).

In order for this new power dynamic to benefit investors over the long term, shareholders must focus on durable, shared value creation, like investments in research that may lead to long-term value for customers, communities and shareholders. Investors also must shun short term tactics that place vital systems at risk.

The last twenty years of corporate governance evolution focused on the "who" question of power allocation among managers, directors and shareholders. Now we must focus on the "why"

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question of the purpose of corporate entities, which we endow with a host of legal advantages.

A relatively new concept, benefit corporation governance, directly addresses this question, without requiring shareholders to surrender any of the gains they have made to date.

This new form should appeal to both long-term investors and corporate managers, and they should work together to bring companies public as benefit corporations and to convert already public corporations into benefit corporations.

Thirty-five jurisdictions in the U.S., including Delaware, the corporate jurisdiction of choice, permit corporations to become benefit corporations if their board and shareholders approve the change.

Benefit corporation rules explicitly reject shareholder primacy and require management decision-making that accounts for the interests of all stakeholders.

Benefit corporation governance is a perfect on-ramp to authentic stewardship. It encourages and enables companies to make profits responsibly and create durable value for all stakeholders.

This structure encourages collaboration with workers, suppliers and customers, who recognize that benefit corporations are authentically committed to their stakeholders, unlike conventional corporations, where shareholder primacy may assert itself at any time.

Benefit corporation law has already reached venture and private equity backed companies, and is beginning to impact the public markets.

On Feb. 1, Laureate Education became the first benefit corporation to go public.[8]

On April 25, DanoneWave, a $6 billion business and wholly owned subsidiary of French multinational Danone, announced it had become the largest benefit corporation.[9]

Shareholders should be active stewards. But that activism must account for the system in which corporations operate, because 80 percent of the return on a diversified portfolio reflects the performance of the market, rather than of individual companies.

Benefit corporations allow corporations and shareholders to manage systemic risk along with entity risk.

While prior governance changes at tradi-tional corporations, such as declassifying boards and adding majority voting, have strengthened the hands of shareholders, they have not addressed weaknesses that allow short term players to game the system and mortgage our future. It's time to change that.

If Etsy or Whole Foods were benefit corporations, would the outcome of their activist campaigns turned out any different? Perhaps not, if their shareholders were legitimately concerned about management quality issues.

If their activists were only interested in finding quick fixes that boosted share price in exchange for mortgaging the future of their corporations and the interests of all their stakeholders, then yes, benefit corporation status could have changed those outcomes by attracting shareholders who shared that long-term vision, and by adding authenticity and credibility to management plans to create durable value over the long run.

Globally, public equity accounts for $75 trillion in value, and this capital must be harnessed for value creation and protected from short term temptations. Capital markets should address, rather than exacerbate, economic instability, inequality, resource scarcity and climate risk.

Benefit corporation governance is a perfect on-ramp to authentic stewardship. It encourages and enables companies to make profits responsibly and create durable value for all stakeholders, including shareholders. This approach may entail more cooperation and more delayed gratification, but that is fine — we are in this together, and in it for the long run.

Benefit corporations can help us reach the vision articulated by DanoneWave CEO Lorna Davis in Fortune Magazine: "In 10 years' time, people will say it's inconceivable that business was done any other way. The notion that a company can only care about profit will be seen as old-fashioned and irresponsible."[10]

NOTES

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[3] Press Release, Whole Foods Market, *Amazon to Acquire Whole Foods Market* (June 16, 2017), http://bit.ly/2sAczZF.

[4] Jeff Mordock and Scott Goss, *DuPont lays off 200 Experimental Station researchers,* The News J., Jan. 5, 2016, http://delonline.us/2tywrs2; Press Release, Dow Chemical Co., *DuPont and Dow to Combine in Merger of Equals* (Dec. 11, 2015) http://bit.ly/2uskdFZ.

[5] Joseph L. Bower & Lynn S. Paine, *The Error at the Heart of Corporate Leadership,* Harvard Bus. Rev., May-June 2017.

[6] Laurence D. Fink, Annual Letter to CEOs (Jan 24, 2017) http://bit.ly/2jsSQ5K.

[7] Ron O'Hanley, Letter and ESG Guidelines (Jan. 26, 2017) http://bit.ly/2usDxCT.

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[8] Lauren Gensler, The World's Biggest For-Profit College Company, Laureate Education, Raises $490 Million In Public Debut, Forbes, Feb. 1, 2017, http://bit.ly/2tjK5nG.

[9] Press Release, DanoneWave, DanoneWave Established as the Largest Public Benefit Corporation in the U.S. (Apr. 25, 2017), http://prn.to/2qaBeib.

[10] Beth Kowitt, This Dairy Company Says Its Business Model Is the Future of Corporate America, Fortune, Apr. 25, 2017, http://for.tn/2q8IQFy.

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