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GOVERNANCE PERSPECTIVES

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Red Light for New Activist Strategy

IN SHORT

The Situation: A proposal by activist investment fund Greenlight Capital sought to divide General Motors's common shares into two classes, only one of which would pay dividends.

The Result: Proxy advisory firms ISS and Glass Lewis recommended against Greenlight's proposal and related proxy contest, both of which were soundly defeated by GM shareholders.

Looking Ahead: Greenlight and other activist shareholders will likely continue to push new strategies designed to "unlock" shareholder value.

Earlier this month, General Motors ("GM") won a decisive victory in a proxy contest waged by Greenlight Capital, the activist fund headed by David Einhorn. Greenlight claimed that GM's shares, which were trading at a price barely above their 2010 IPO price, were significantly undervalued because the market was not properly assessing the sizeable cash dividends paid on the shares. Greenlight proposed that GM's shares be split into two classes—a class of "dividend shares" that would have one-tenth of a vote per share and would be entitled to quarterly cash dividends at the current annual rate, and a class of "capital appreciation shares" that would have one vote per share and would be entitled to GM's earnings in excess of the dividends paid on the dividend shares.

Greenlight claimed this change to GM's capital structure would lead to a substantial increase in GM's market capitalization, improve GM's access to capital, attract new investors, and unlock billions in value for all GM shareholders, without affecting GM's business strategy, operations, or financial flexibility.

Greenlight first presented its proposal to GM's board of directors in 2016. The GM board rejected the proposal, concluding that it:

- Did not address the fundamental, industry-wide factors driving GM's valuation;
- Would result in a loss of GM's investment grade credit rating;
- Could result in a lower GM share price; and
- Could create governance conflicts, due to the divergent objectives of the two classes of shares.

In March 2017, Greenlight took its proposal directly to GM's shareholders as part of its proxy contest for three seats on the GM board. Both key proxy advisory firms, ISS and Glass Lewis, recommended that GM shareholders vote against the Greenlight campaign.

Ultimately, Greenlight failed to garner much support for its campaign from GM's shareholders—its proposal was defeated by more than 91 percent of votes cast, and all of GM's director nominees were elected with 84 percent or more of the votes cast. Despite the decisive outcome of the GM shareholder vote, the takeaways from the GM proxy contest may not necessarily be preordained.

Importantly, ISS concluded that, while the Greenlight proposal "appears to work on paper given the right assumptions," and Greenlight had nominated a "credible" slate of directors, the proposal's value creation was uncertain. ISS also acknowledged that the proposal would create conflicts of interest among GM's shareholders because of the differing objectives of the holders of the two classes. On balance, ISS recommended against the Greenlight proposal, citing its risks and the lack of visibility regarding value creation for GM shareholders. Notably, other organizations purporting to speak for institutional holders, like Investor Stewardship Group, also strongly oppose dual class share structures that create unequal voting rights among shareholders and have formalized this view in their governance policies.

> The Greenlight proposal would inevitably and directly pit classes of shareholders against one another and put the board in the untenable position of perpetually reconciling these interests rather than overseeing the business of the company from a long-term point of view.

Many of the hundreds of activist campaigns launched over the past decade proposed one of a handful of familiar strategies in order to "unlock" shareholder value, chief among them a change in the board or management, a different capital allocation strategy, or a strategic transaction. The Greenlight proposal, while novel, has many of the hallmarks of basic activist themes, and Greenlight and others can be expected to push new themes, especially as the bloom begins to come off the bedrock ideas like stock buy-backs. Having said this, the Greenlight proposal would inevitably and directly pit classes of shareholders against one another and put the board in the untenable position of perpetually reconciling these interests rather than overseeing the business of the company from a long-term point of view.

To us, the failed Greenlight proposal stands for the proposition that financial engineering for its own sake is not an effective activist strategy. The Greenlight situation, coupled with other recent events like the public calls by major investment firms for a more balanced focus on corporate investment, rather than the maximization of short-term capital returns, suggests that investors are willing to allow companies to reinvest for the future in cases where management has articulated a sound strategy.

THREE KEY TAKEAWAYS

1. GM's shareholders soundly defeated activist Greenlight Capital's proxy contest and proposal to divide GM's common shares into two classes, only one of which would pay dividends.
2. Proxy advisory firms ISS and Glass Lewis recommended against Greenlight's proposal.
3. The Greenlight proposal was unconventional, untested, and would create a dual class stock structure that invites conflicts of interests.

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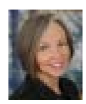

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