Strategies for Handling Activist Investors

In his regular column, Frank Aquila drafts a memo to a board providing recommendations on how the company can handle potential activist campaigns, including by increasing shareholder engagement.

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MEMORANDUM
TO: The Board of Directors
FROM: Frank Aquila
RE: Strategies for Handling Activist Investors

Shareholder activism continues to evolve, expand and increase in influence. There is a growing emphasis, in particular by large mutual funds and other traditional institutional investors, on shareholder engagement and shareholder-friendly governance structures that, together with the increased activity of activist hedge funds and other “strategic” activist investors, make shareholder engagement and preparedness an essential focus for the boards of public companies.
Beyond activist investors, large traditional institutional investors have made public and private statements indicating that they will continue to focus on corporate governance and that they desire an increased level of board engagement with companies in which they invest. This means that shareholder activism, in terms of corporate governance and shareholder relations, has become a serious topic that must be regularly addressed by the boards of all public companies.

I am pleased to brief the Board on current trends in shareholder activism and provide recommendations on how the Company can handle potential activist campaigns, including:

- Understanding the different approaches to shareholder activism.
- Studying the possible lines of attack.
- Integrating preparation efforts into regular board processes.
- Understanding the impact of corporate governance as a focus area for institutional investors.
- Considering appropriate structures for oversight of and involvement in shareholder engagement.
- Reviewing the company’s organizational documents.
- Preparing a response plan.
- Evaluating other general considerations.

1. OVERVIEW OF SHAREHOLDER ACTIVISM

Shareholder activism, which began as a targeted effort by a small number of governance activists, supported by some academics, clearly is now a mainstream concept among institutional investors that is redefining the relationship between public companies and their shareholders. This evolution will no doubt continue, and as a consequence, companies and their boards should recognize that shareholder relations models of the past, as well as “traditional” approaches to responding to shareholder initiatives, may no longer be optimal or even desirable.

Activist hedge funds have been extremely successful, attracting well over $200 billion in investor funds in recent years. Much of the investments in activist hedge funds have come from pension funds and other traditional institutional investors. While there may be a lively debate about the long-term impact of shareholder activism on US businesses, there is no question that activists in many cases have achieved short-term positive returns in recent years that have been greater than those of other, more traditional asset managers. Activist campaigns are now regularly garnering the support of many traditionally more passive shareholders. As a result, even the largest, most respected companies may be subject to the attention of activists.

Major activist hedge funds are very knowledgeable and focused, and have built up their staff, including analysts, to rival traditional financial advisors. They are capable of producing detailed presentations and papers that analyze a company’s operations, capital structure and strategy, and highlight perceived mistakes or failures by management.

Support for these activists is strong and crosses a wide range of investors. Traditional institutional investors may not want to take action on their own, but are willing to back and communicate with activists regarding companies they believe would benefit from a shake-up. Pension funds, sovereign wealth funds and other non-activist funds may also be willing to support activists in the future.

Activists often benefit from poor or non-existent lines of communication between companies and their shareholders, a situation which becomes exacerbated in times of crisis. Activists may have also benefited from a perceived general decrease in investor trust in the thoughtfulness and diligence of boards and management following the financial crisis.

Companies should take, and most are taking, these developments very seriously. Both directors and executive officers are proactively considering possible activist initiatives and discussing them at board meetings. Companies are devoting greater effort to communicating with shareholders and are beginning to arrange for direct communications between shareholders and outside directors. Although strict adherence to Regulation FD is essential, overall this is a positive trend and one that should continue to develop. It appears that both companies and shareholders are feeling their way towards a new relationship with significantly greater shareholder dialogue.
and engagement. This is a complex process that will take time and will vary across companies. Although there have been many changes in the board/shareholder dynamic in the last several years, in many ways this area remains in transition.

2. APPROACHES TO SHAREHOLDER ACTIVISM

There is no one-size-fits-all approach to shareholder activism. Small differences in circumstances can lead to substantial differences in the options available to optimize outcomes.

Factors that can impact an activist’s success include:
- The size of the company’s equity capitalization.
- The identity of the company’s shareholders.
- The identity and track record of the activist.
- The nature and attractiveness of an activist proposal.
- The company’s potential responses to the activist proposal.
- The total shareholder return of the company in recent years.
- The media profile of the company and the activist.
- The overall governance profile of the company. Key elements of the governance profile that may trigger an activist’s interest include:
  - structural defenses;
  - director tenure;
  - director expertise; and
  - compensation structures.

3. POSSIBLE LINES OF ATTACK

It is essential that the Board, management and the Company’s advisors thoughtfully consider possible activist lines of attack before the attack surfaces. The Company should evaluate whether any actions that might be advocated should be implemented and, if not, develop a clear explanation for why doing so is not advisable. This process should be rigorous and fact-based, and should seek to anticipate activist counter-arguments to the Company’s position. The Company should also consider proactively informing investors about its analysis of alternatives to create value, including previewing for investors why some superficially appealing actions are not advisable.

Activists typically lead with one of three types of propositions:
- **Returning excess cash to shareholders.** This can be achieved through special or increased dividends or share repurchases. In the current economic environment, this may be combined with a suggestion to pay for these programs by issuing additional debt.
- **Engaging in material business transactions.** For example, these transactions may include acquisitions, divestitures, roll-ups, spin-offs or split-offs. The activist may propose combinations that could achieve additional synergies or break-ups that could unlock value for the businesses that are separated.
- **Improving existing operations.** The activist may promote new approaches for profitability or offer alternative suggestions on running the business.

Regardless of which tactic an activist begins with, the debate typically moves on to calls for changes in board composition or management, or even a sale of the entire company.

The Company should begin preparing supplemental materials, such as talking points, communications to shareholders and other investor or analyst presentations, in advance of any activist approach that explain in clear language why pre-identified strategies or alternatives are not advisable. Although the amount of effort devoted to the preparation of materials may vary across companies, once an activist gets traction with shareholders, it can be difficult for a company to turn things around. Therefore, preemption of activist proposals or, if preemption is not possible, a speedy response, is essential.
4. INTEGRATING PREPARATION EFFORTS
Management and the Company’s advisors should keep the Board apprised of:
- General trends in shareholder activism.
- Specific activist tactics.
- Possible avenues of activist attack.
- Potential company responses.

Although the Company is doing this to some extent today, the process should become a regular part of the annual board calendar and should be integrated with board discussions on strategic planning and capital allocation. If an activist emerges, a high level of board involvement and cohesion will be essential, and the Board should focus on the development of these characteristics in advance.

5. EMPHASIS ON CORPORATE GOVERNANCE BY INSTITUTIONAL INVESTORS
Index funds are the ultimate long-term investors. They dominate the stock market, and their obligation to their investors is to support an environment that creates the best chance to maximize permanently the overall value of public equity securities. These index fund managers have decided that one way to maximize value in an enduring way is to focus on the quality of corporate governance.

The good news is that this focus gives public companies a path to obtaining the support of these index funds, which control an ever-increasing proportion of the votes at public companies. It also reduces the influence of proxy advisory firms. The bad news is that procuring the support of the index funds, at this point, can require significant adherence to a “check the box” litany of governance initiatives, not all of which are appropriate or advisable for every company.

However, the Company should focus carefully on these initiatives, and its relationships overall with these investors. The support of these index funds often will be decisive in any activist campaign. Index fund managers will be inclined to support boards and managements that they believe:
- Are properly selected for their experiences, expertise and independence.
- Have demonstrated openness to shareholder engagement.
- Have shown an appropriate level of oversight over corporate affairs and, in the case of directors, management and management compensation.

This is also the basis on which increased director interaction with shareholders can be helpful to demonstrate the appropriate functioning of a particular board.

6. STRUCTURES FOR BOARD OVERSIGHT OF SHAREHOLDER ENGAGEMENT
As discussed above, the Board should be kept apprised of shareholder outreach efforts, feedback from shareholders, and trends or developments regarding shareholder activism. The regularity and format of the presentation of this information will vary across companies, as will the formality of board structures and processes for overseeing these areas. For example, one large institutional investor has suggested the creation of a “shareholder liaison committee” as a possible means to facilitate board/shareholder communication. In addition, a number of large institutions have recently advocated the creation of a formal shareholder engagement policy.

The Company may determine that these types of formal measures are not necessary or appropriate. Even so, the Company and the Board should consider how best to effect the Board’s oversight of shareholder engagement and, where appropriate, contribute to that engagement. The Company may find that, while a stand-alone shareholder liaison committee is not necessary, the mandate of its governance committee could be formally expanded to cover oversight of shareholder engagement. Even if no formal changes are made, the Company should take steps to make sure that regular updates and presentations on shareholder engagement matters are included on the agendas for the Board and relevant committees.
As companies have expanded their shareholder engagement efforts, both within and outside of activist situations, a frequent topic of commentary has been the involvement of directors in meeting directly with shareholders. Practice has varied significantly, depending largely on the predilections of particular directors and the expressed interest of key shareholders in these meetings. To date, most companies have made these decisions in an ad hoc manner and, until recently, direct board and shareholder discussions have been relatively unusual outside of a takeover or other crisis situation. It is clear that director/shareholder engagement will be a continuing and increasing area of focus for shareholders. Public statements by large institutional investors in the recent past serve as indications that they will press for communications that include outside directors.

It seems unlikely that director meetings will ever be the primary means for shareholders to interact with companies. Because of the oversight function of the board, directors cannot be expected to have the details regarding business matters that shareholders generally wish to discuss. In addition, many companies have adopted Regulation FD policies under which directors, other than a lead director or chairman of the board, are not authorized to speak on behalf of the company or discuss material company information with shareholders. However, it may become more common for directors to meet with large shareholders to discuss matters that are within the directors’ purview, including governance structures, executive compensation and solicitation of shareholders’ views on other topics.

Even if the Company has not received shareholder requests for meetings with directors, the Company should anticipate that these requests will be coming soon. The first step is to discuss the concept with the Board. Ultimately, the level of director/shareholder engagement will turn on the comfort level that the Board has with particular directors engaging directly with shareholders on certain topics.

Generally speaking, Regulation FD and confidentiality concerns should not be used as a bar to director/shareholder engagement, because these meetings should not include, and can be structured to avoid, the disclosure of material nonpublic information. Of course, appropriate steps should be taken to help avoid missteps, including:

- Conducting director training on Regulation FD and the Company’s Regulation FD policy.
- Involving the Company’s general counsel or other appropriate company personnel in any director/shareholder meetings.
- Imposing limitations on the topics to be discussed.

7. ORGANIZATIONAL DOCUMENT REVIEW

Corporate by-laws can establish some useful and equitable rules for the types of corporate actions sometimes initiated by activists, including calling special meetings of shareholders and nominating candidates for director. The Company should carefully review its by-laws with its advisors and consider whether changes are appropriate. By-law changes are an area that requires judgment, and clearly an area where one size does not fit all. A by-law change that would pass unnoticed at some companies may be seen as inflammatory at others. Shareholders are increasingly sensitive to board actions (such as by-law changes) affecting shareholder rights without prior shareholder consultation or approval.

The by-laws should include customary provisions that ensure that the Board will be fully informed of any activist efforts. Specific areas to consider include:

- Whether directors can be removed by shareholders without cause.
- Whether shareholders can act by written consent or call a special meeting, and at what threshold ownership levels.
- How far in advance shareholders must give notice of an intention to make a proposal or nominate a director at an annual meeting (advance notice provisions).
- What disclosure is required of director nominees.
- Whether there should be qualification requirements for directors, such as an absence of third-party compensation for director service.
Whether the by-laws should establish an exclusive forum for shareholder class actions (exclusive forum provisions).

Whether a board by-law change should preemptively address proxy access (proxy access by-laws).

8. RESPONSE PLAN

Although increased shareholder engagement may lessen the likelihood of an activist campaign against the Company, it will not immunize it. The Board and management should adopt a proactive strategy to anticipate and defend against the potential for an activist campaign. That response plan should be thorough and well-considered. Specific steps that the Company should be taking now include:

- Assembling and educating a core response team.
- Identifying areas of potential vulnerability.
- Taking appropriate preemptive actions.
- Monitoring the shareholder base.

A. ASSEMBLE AND EDUCATE A TEAM

The Company should assemble a core response team, including both internal personnel and external advisors. Company personnel on the response team should include senior management, directors, the general counsel and other legal personnel and members of the investor relations department. External advisors on the response team should include representatives from the Company’s outside legal counsel, financial advisor, public relations firm and proxy solicitor.

B. IDENTIFY VULNERABILITIES

The Company can approach the task of identifying vulnerable areas by thinking like an activist. The Board and management should:

- Consider how an activist would criticize the Company and what an activist would request.
- Identify areas of potential vulnerability, including the Company’s governance, financial performance, strategy and capital structure.
- Undertake a review of the Company’s organizational documents, material contracts and executive compensation program. The Company should look for problematic practices, such as change in control provisions and governance “hot button” issues. The Board should undertake a robust self-assessment, as investors are increasingly scrutinizing director qualifications and board composition.

C. TAKE PREEMPTIVE ACTION

The Board should consider taking appropriate preemptive actions, including enhancing structural defenses. For example, the Board should evaluate whether to adopt a poison pill. The Board should keep in mind that a poison pill may only provide protection from certain types of activists and transactions in the short term. It may not impact an activist’s ability to challenge management in a proxy contest, and may also harm relations with shareholders.

The Board and management should formulate a crisis response plan for an activist challenge. Key steps include:

- Acknowledging the activist quickly and respectfully.
- Engaging with the activist on the merits of the proposal.
- Looking for areas of common ground with the activist.
- Being open-minded and careful when considering or taking actions.
- Engaging with other shareholders regarding the activist’s proposal and the alternatives.

The Company should also develop a communications response plan. In addition to engaging with shareholders, the Company should establish a process for other key communications, including:
■ Public messaging.
■ Employee outreach.
■ Meetings with Institutional Shareholder Services Inc. and other proxy advisory firms regarding their governance reporting.

D. MONITOR SHAREHOLDER BASE

The Company should actively monitor its shareholder base, paying particular attention to changes in holdings by hedge funds and institutional investors. The Company should also engage with its shareholders, maintaining regular contact with its large shareholders, and focus on understanding their concerns and ensuring regular communications from management to address issues. As part of its engagement strategy, the Company should regularly communicate its strategic plan and vision to its shareholder base and promote a consistent message.

9. OTHER KEY CONSIDERATIONS

This period of transition may be challenging. Activists seem to be achieving more success than would appear to be warranted by the strength of their ideas or proposals for change. At the same time, institutional investors are becoming more active in how they reach out to and interact with their portfolio companies. As a result, the Company should think about what it can do differently to change the existing dynamic so that the better substantive, value-creating position prevails.

In addition to some of the concrete steps outlined above, the Company should consider generally:
■ The increasing concentration in public company share ownership.
■ The incentives affecting the interests of public company shareholders, especially the index fund investors.
■ The demonstrated ineffectiveness of focusing the substantive debate primarily on “short-termism.”
■ The reasons for activist success.

This is a complex analysis and, in many cases, additional action will be necessary. However, undertaking this analysis and making appropriate adjustments will make it easier to prevent and, if prevention fails, prevail against, an activist challenge.

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I look forward to discussing these issues with you further at your next meeting.

F.J.A.