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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Recent Trends In Shareholder Activism

By **Warren de Wied, Philip Richter and Gail Weinstein**
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Warren de Wied


Philip Richter


Gail Weinstein

Shareholder activism and corporate America's response to it continue to evolve. Perhaps the most significant impact of activism has been a more robust and extensive engagement between companies and their shareholders. Although activism faces headwinds — notably, generally poor financial performance among activist funds and now an absence of "low-hanging fruit" targets in the U.S. — the number of public activist campaigns has increased sharply in 2018 (following a slowing trend in 2016 and 2017).

Recent Trends in Activism

Concentration of Activity Among Leading Activists

2018 has seen a concentration of activity among a number of leading activists, with the 10 most active activist funds accounting for about a third of the total number of new campaigns, and a continuing decline in the number of first-time activists (since a peak in 2014).

Average Market Capitalization of Targets Is Higher, But Supercap Targets Remain Infrequent

While the average size of companies targeted has been getting larger, campaigns targeting supercap companies remain infrequent, and the most frequently targeted companies have been those with a market capitalization in the range of $100 million-$500 million. Notably, however, the campaigns that have targeted extremely large companies were brought by a broad range of activists.

M&A Is the Most Common Objective of Campaigns

Although board change is a primary publicly stated objective in many announced public campaigns, a value maximization thesis usually underpins campaigns for board change. Campaigns focused on governance, operations or management change have been less frequent this year, and campaigns focused on business strategy and capital allocation or return (i.e., seeking stock buybacks or increased dividends) have been more frequent, as compared to recent years.

Few Activist Campaigns Go to a Shareholder Vote

Few activist campaigns have gone to a shareholder vote, and in the most recent years, almost all board seats obtained by activists have been achieved through settlements rather than shareholder votes. Issuers in general are more willing to settle with activists nowadays rather than engage in a protracted and costly public fight with an uncertain outcome. In many cases, a settlement may involve adding new independent directors, but does not require the issuer to add a representative of the activist to its board, and, as activist nominees have become a frequent presence in boardrooms, concerns about the impact of these directors on board dynamics have been tempered to some degree. Most settlements are achieved before a preliminary proxy statement is filed. Once parties have begun to trade blows by the filing of preliminary proxy materials and other pre-commencement materials, it becomes more difficult to settle, and settlements after the mailing of the definitive proxy materials are rarer still. As a general rule, activists tend to accede to more favorable terms to the issuer in earlier settlements. In 2018, there has been a sharp increase, among companies ceding board seats to activists, in those that ceded three or more seats.

"Long-Slate" Campaigns Have Increased, Although They Remain Infrequent

There has been an increase since 2014 in activists' long-slate campaigns, and we note that one activist, Starboard, now routinely submits nominations for 50 percent or more of the board seats in its campaigns. However, there were only three full-blown long-slate proxy contests by activists in the 2018 proxy season: Third Point's campaign at Campbell Soup (which is pending, with the annual meeting to be held in November 2018), Carl Icahn's campaign at SandRidge (which was settled, with Icahn gaining control of the board); and Blackwell's campaign at SuperValu (which was settled without board seats gained). Starboard initiated a proxy contest seeking to oust the entire 12-person board at Newell Brands, but scaled back its slate to four nominees after Icahn obtained four seats, and Starboard ultimately settled for two seats. Starboard also sought four of the eight seats at Cars.com, but ultimately settled for two seats.

A Sharp Increase in Activism in Europe

The amount of capital deployed in public activist campaigns in Europe has surged and represents about 25 percent of activists' capital deployed globally (although Elliott Management Corp. alone accounts for almost one-third of the European campaigns).

The Impact and Future of Activism

Change in the Cadence of M&A Activity

In a reversal of the patterns of the recent past, today most "friendly" — i.e., negotiated — M&A transactions are initiated by a bidder rather than by a target company's decision to initiate a process to sell the company. Concurrently, there has been a significant increase in "hostile" — i.e., unsolicited — M&A bids. The potential for activism has made companies more cautious about rejecting a credible, private acquisition proposal. In those cases where the bidder chooses to makes its interest known publicly, it can generally count upon activist investors to emerge and increase the pressure on a company that resists the bid. Activists may also surface after a failed unsolicited offer seeking to oust recalcitrant board members. At the same time, the threat of activist involvement can discourage companies from proposing a sale that may be questioned by shareholders.

Ongoing Impact on a Company After a Campaign

Activists nowadays often do not just "go away." A settlement that adds activist-minded directors to the board changes the dynamics in the boardroom and frequently leads to M&A transactions or changes in business strategy or management. Insiders of an activist fund who are appointed to a target company board pursuant to a settlement agreement now often retain their seats (according to one study, for up to two years on average) beyond the minimum term required in the settlement agreement. Even after losing a proxy contest vote or otherwise retreating from a campaign, an activist may continue to pressure the company or launch additional campaigns against it. Activists now regularly hold an investment for several years, and companies may become serial targets for activists. (According to one study, 20 percent of targets of activist campaigns in 2017 had been a target within the previous five years.)

Pivotal Role of Institutional Investors

Given the concentration of equity ownership among institutional investors, an activist's success typically will depend on convincing only a small number of investors of the credibility of the activist's thesis. Activists' ownership interest in companies they target is generally low (below a median of 10 percent, and at companies with a capitalization over $20 billion, less than 2 percent). The top three institutional investors alone own in the aggregate about 20 percent of S&P 500 companies (and the top 10 own over 30 percent). The most frequent activists have developed significant relationships with the largest institutional investors, and these investors have increasingly been willing to support activist campaigns.

Companies have responded by ramping up their engagement with institutional holders, including through "nondeal roadshows." Increased engagement by companies with their major shareholders can be highly beneficial. However, it can be difficult for companies — particularly smaller ones — to develop decision maker-level relationships with the major institutional investors, which have limited availability and have many companies competing for space on their calendars. Although the top institutional investors own a significant percentage of the equity of many companies, they are generally reluctant to take public (or even nonpublic) positions (ahead of a vote) on disputes between activists and boards due to concerns about potentially losing their status as "passive" investors and, as a result, becoming subject to the reporting and short-swing profit provisions of Section 16 and the more onerous reporting obligations of a Schedule 13D filer. Since many of these investors are index funds, it is impracticable for them to engage in activities that would require them to refrain from trading.

Generally Poor Financial Results of Activist Funds

While some activist hedge funds had significant profits in the most recent couple of years, most activist funds significantly underperformed market indexes. Last year, following record losses in the second half of 2015 and record gains in the second half of 2016 for activist funds, the return to investors in activist funds in 2017 averaged under 4 percent. This return was just slightly above the average return for hedge funds overall and significantly lagged the returns of the Dow Jones Industrial Average (24 percent) and the S&P 500 Index (18.7 percent). In addition, returns for activist funds have continued to be highly volatile on a quarterly basis.

Likely Increased Aggressiveness in the Near Future

As noted, activist funds' financial performance has been generally poor, activists have been holding their investments for longer periods, and directors appointed in settlement agreements have been serving longer than the required period. In addition, activists have harvested many of the "low-hanging fruit" targets in the U.S. These trends may portend, in the near future, a decline in activism generally, a continued thinning of the ranks of lesser-scale activist funds, or (in our view, more likely given the high level of assets under management by activist funds) an increasingly aggressive posture by activists as they attempt to drive profitability (such as by increased emphasis on M&A, CEO replacement, and/or other high-impact actions). These trends also are likely to continue to fuel the expansion of activism outside the U.S.

Likely New Focus on Sexual Harassment Issues

In the current environment, we expect that activists are likely to make aggressive use of private investigators, including with respect to workplace sexual harassment and abuse issues. (Activists — and issuers, too — have long used private investigators to obtain information that can be used in activist campaigns and proxy contests — a practice highlighted in a recent New Yorker article discussing a recent campaign at Athenahealth by Paul Singer and his firm, Elliott Management, although Elliott denied a number of statements made in the article.) In our view, sexual harassment and abuse issues are likely to become a catalyst for activist activity, as more high-profile companies are affected and their boards are confronted with related, unanticipated succession and governance challenges. We note that, in the 2018 proxy season, major institutional investors, including BlackRock and the California Public Employees' Retirement System, issued new policies or statements emphasizing sexual harassment issues. Also, 2018 saw the first shareholder proposals submitted by activists relating to workplace sexual harassment — by Trillium Asset Management at Nike and by Arjuna Capital, jointly with the New York State Common Retirement Fund, at both Facebook and Twitter. These developments are occurring against a backdrop of continuing institutional investor emphasis on board gender diversity and gender pay gaps. State Street indicated that in 2018 it has voted against certain directors at more than 500 companies based on a failure to address the issue of board diversity.

Possible Increased Emphasis on ESG (Including Nonconventional ESG) Issues

Some observers have speculated that institutional investors' general focus, and their recent much more vocal emphasis, on corporate "stewardship," "long-termism," and environmental, social and governance issues may lead to an accelerated focus by activists on governance-related topics going forward. Institutional investors have continued to ramp up their focus on ESG-related issues, including board diversity and refreshment, employee diversity, environment, sustainability and climate change. Notably, the New York City Pension Funds' Boardroom Accountability Project (which recently completed a very successful campaign for the adoption by companies of proxy access bylaws) has begun a campaign relating to board diversity, which calls on companies to disclose, on a standard matrix, information about the race, gender and skills of their directors. We query whether some institutional investors may expand their focus beyond conventional ESG to other political, economic and social issues that appear to directly and significantly impact corporations (such as, possibly, federal immigration or trade/tariff policies).

Other Issues to Watch For

The Markets

The long-running bull market has driven an M&A boom and helped to insulate activists (who are typically long-only holders, often with illiquid positions) against downside risk. A major correction, with tightened credit markets, would present serious challenges to many activists and would likely lead to a significant reshaping of the activist landscape.

Regulatory Matters

Universal Proxy Cards: Will issuers face increased pressure from shareholders to permit a universal card in proxy contests? (In the absence of a U.S. Securities and Exchange Commission requirement that companies permit a universal proxy card, its use in any given contest requires both parties' consent.) Absent action by the SEC, might investors seek to use the Rule 14a-8 shareholder proposal mechanism to pressure companies to adopt bylaws that require companies to allow universal proxy cards? (This tactic was responsible for the widespread adoption of proxy access bylaws. The SEC has indicated that it will again be taking up the issue of requiring universal proxy cards.) Will the SEC move to require universal proxy access? (Portending a possible reversal of the SEC's recent approach, in mid-September, SEC Chairman Jay Clayton suggested, in comments to reporters following an investor advisory committee meeting, that the SEC may soon act to require universal proxy access.)

Increased Scrutiny of Institutional Investors: Will institutional investors' increased concentration of ownership of S&P 500 companies, increased assets under management, and more vocal responses to activist campaigns and other corporate issues prompt increased regulatory scrutiny?

Future of Proxy Advisory Firms: Will the influence of proxy advisory firm recommendations diminish further as institutional investors continue to expand their sphere of influence and their in-house capacity to evaluate activist campaigns? Will legislation be adopted that impacts the activities of proxy advisory firms? (We note that in mid-September 2018, citing an intent to encourage discussion at an upcoming fall 2018 roundtable discussion on the proxy system, the SEC staff withdrew guidance issued in 2004 in two interpretative letters that facilitated institutional investors' reliance on proxy advisory firm recommendations. However, the SEC did not withdraw related guidance provided in a 2014 staff legal bulletin. Thus, the impact of the withdrawal of the interpretive letters is uncertain at this point.)

Schedule 13D Enforcement: Will the SEC more strenuously seek to apply Schedule 13D filing requirements on activists when a control intent may be apparent, as was the case in the SEC's February 2017 enforcement action against a group of activists who had been involved together in campaigns targeting microcap companies without, according to the SEC, disclosing their group status and/or intent to influence control of the target companies?

HSR Enforcement.: Will the Federal Trade Commission and the U.S. Department of Justice more strenuously seek to apply Hart-Scott-Rodino Act filing requirements on activists who do not appear to be "passive" investors, as was the case in their 2016 enforcement action against ValueAct?

Campaign Tactics

Poison Pills: Will "acting in concert" poison pills be adopted by companies in response to activist approaches — and, if so, how aggressively will the courts interpret these pills?

Withhold Campaigns and Nomination Deadline Challenges: Will activists increasingly utilize high-profile withhold campaigns and/or challenges to advance notice bylaw deadlines (based on an alleged material change in circumstances since the passing of the deadline) in furtherance of their pursuit of board seats — as was seen in a handful of campaigns in the first half of 2018?

Practice Points

Plan proactively to mitigate activism risk.

The essential practice point has been and remains that proactive planning — and a relentless focus on performance and execution — are critical to an effective activism risk mitigation plan. Companies, together with outside advisers, should "think like an activist" to identify and (where appropriate) address potential vulnerabilities that may attract activist scrutiny. Where issues are identified, a company should consider whether action is appropriate and, if so, move promptly to take action, as the window for companies to execute self-help strategies has narrowed. If the board does not believe an approach that may be supported by an activist is appropriate for the company, it should ensure that its rationale is clearly articulated to investors. A company also should be mindful that activists typically invest on a dip in the stock price, and how the company discloses, and responds to, adverse developments can play a critical role in maintaining institutional investor support if an activist surfaces.

Regularly evaluate shareholder engagement programs and investor feedback.

Companies should regularly assess the effectiveness of their shareholder engagement programs and the feedback received from investors. Many companies now conduct "nondeal roadshows" and more companies are involving the lead director or committee chairs in shareholder engagement on governance issues. Companies should not wait for an activist to surface to strengthen these relationships. Even companies with rigorous shareholder engagement programs should be mindful that the identity and views of their investors may change over time.

Keep the board informed.

The sudden onset of an activist campaign can put the company off balance and lead to disruption in the boardroom and, possibly, tension between the board and management. This is particularly true where the activist raises issues about the company's performance — particularly as it relates to that of the company's peers — that the board may have been unaware of. Accordingly, it is important that boards be regularly apprised of concerns raised with management by investors and analysts, and of the company's performance compared to its peers. A board that is well-informed about activism in general and is regularly briefed on company-specific issues that impact the company's risk profile can approach an activist situation with a greater sense of confidence and navigate to a superior outcome. The board should interact with its activism response team and plan before the company becomes a target.

Be proactive in evaluating (and, if appropriate, making changes to) the board.

Ultimately, composition of the board becomes the focus of most activist campaigns. As a matter of general good governance and to reduce the risk of being targeted by activists, boards should be proactive in making changes to address any actual or perceived deficiencies with respect to board independence, areas of expertise, tenure, diversity and/or attendance. Smaller-cap companies in particular may wish to be proactive in this respect (as, in general, they may have a more difficult time locating satisfactory directors on short notice, may have more (at least perceived) deficiencies in these areas, and may be more negatively impacted by the time and other demands of an activist approach). In some cases, companies may wish to consider consulting with their major shareholders regarding board changes.

Be mindful that M&A-related activism may become more aggressive.

While activism related to M&A typically has involved an announced or rumored deal and an activist seeking to improve the price and/or terms being discussed or to block the deal, companies should be mindful that activists may become even more aggressive with respect to M&A as they seek to drive greater profitability. They may, for example, seek more often to stimulate the sale of independent companies, and in that connection may themselves identify and contact particular potential buyers, likely after acquiring an equity stake in the target. Further, activists may acquire target company out-of-the-money options, in lieu of or in combination with stock, when acquiring their equity stake in the target, when the activist has a relatively high degree of confidence that an M&A transaction or other value-enhancing action is likely to occur, and has a relatively higher risk tolerance in connection with seeking to achieve, potentially, significantly higher returns. We note that activists have not followed, and are not likely to follow, the Pershing Square-Valeant model used in 2014, where the activist acquired an equity stake in the target after teaming up as a kind of co-bidder with the corporate bidder, and where the activist used in-the-money options to acquire the equity stake.

Be mindful that CEO succession uncertainty may attract activist interest.

As a general matter, and as a proactive disincentive to activist interest, companies should ensure that they have and make public their succession plans if the CEO is approaching retirement age.

Given increased liquidity, review plans for capital allocation and return.

Although M&A and board change have been the most common objectives of activist campaigns in recent years, the significant increases in corporate liquidity resulting from robust economic conditions and the 2017 federal tax changes may lead to a return to more activism relating to capital allocation and return. Companies should consider whether their plans for use of excess cash (including, for example, for stock buybacks and/or dividends) are well-formulated, publicly known and viewed generally as being in the shareholders' interest.

Take possible activist interest into account when considering and structuring any M&A deal.

Any large acquisition by a company may trigger activist interest. Further, as transactions requiring shareholder approval may increase the likelihood of attracting activist attention, companies might consider whether an alternative structure that achieves the same business objectives without a shareholder vote being required would be preferable. In connection with an M&A transaction, a team dedicated to responding to activist challenges should be in place and prepared to act.

Be prepared to respond to an activist approach.

Of course, companies can become targets for activists notwithstanding rigorous self-assessment and proactive measures to improve performance, execution, value creation and governance. The company should have a response plan in place, although any such plan must be reviewed and updated if an activist does surface. The appropriate response will depend on a nuanced assessment by management, the board and the company's outside advisers of all of the facts and circumstances at the time — including who the activist is; the nature, tone and subject matter of the approach; the company's shareholder base; the company's past and expected performance; and its corporate governance profile and defensive posture. The guiding principles should be coordination of all action through the company's dedicated team; maintaining the company's credibility in the face of pressure (which can include aggressive attacks) from the activist; communication of a compelling rationale for the company's actions and a consistent and effective message about the company's focus on, strategy for, and specific plans for long-term value creation; and consistent attention to the company's reputation and its past and/or prospects for strong performance. It should be kept in mind that, depending on the circumstances, "stonewalling" or "war" may not be a productive response; that, generally, an activist's ideas should be carefully evaluated; and that compromise ultimately may be the preferred resolution. Although activists like to create a sense of urgency, there is usually ample time to evaluate the situation, and a rush to judgment (whether in the form of a rebuff or compromise with the activist) may not be the optimal approach and may alienate the company's institutional shareholders.

Warren S. de Wied and Philip Richter are partners at Fried Frank Harris Shriver & Jacobson LLP.

Gail Weinstein is a senior counsel at the firm.