

Securities Advisory

# Activism: An Overview from the Company Perspective

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## Background

Increasingly, companies are being confronted with shareholders seeking to exercise power and influence over business activities. The term “activism” has become a buzzword to refer to shareholders seeking to make operational, governance, and structural changes in the companies in which they own a stake. Activists sometimes seek to influence other shareholders to rally behind their cause. Activists may seek to add or replace board directors, drive spin-offs, mergers or acquisitions, spur the payment of dividends and buybacks, affect executive compensation, reallocate capital, or influence operational and strategic direction.

Having an activist shareholder can ultimately prove productive, neutral, or unproductive relative to long-term shareholder interests. Much depends on whether the activist shareholder has taken a genuine analytical look at the company and its prospects or is simply seeking changes that would result in a short-term increase in share price at the expense of long-term business values. And, of course, whether the intervention is productive or nonproductive can be very much in the eye of the beholder. As discussed below, there are many situations where companies have been able to work in collaboration with an activist shareholder; there are others where management and the company’s board will determine that the activist’s proposals are not in the company’s and its shareholders’ long-term best interest and will be compelled to take action to protect that interest.

Company boards of directors have many decisions to make in their responses to activists. Acquiescing to activist requests, collaborating and compromising with activists, or rejecting and defending against activist influence are all options. In response to shareholder activism, companies can make, and sometimes have made, the changes demanded. For example, after discussions with activists, companies have given up their staggered boards, made it easier for shareholders to call meetings of stockholders, allowed majority voting for directors, modified executive compensation packages, and installed new board members as well as made structural changes, such as spin-offs, reconfiguring corporate real estate holdings, selling off non-core enterprises not making a positive contribution to company results, and abandoning long-term strategies and liquidating via an extraordinary dividend to shareholders.

Company leadership may consider activist requests and ultimately disagree with the merits of their proposals. Indeed, some companies have simply decided that they do not want to entertain the actions of shareholder activists at all, and work to deflect their demands.

What is a company to do when faced with an activist who continues to pursue action? What about when such action becomes aggressive? We suggest practices that can better prepare a company to deal with activism if and when it does occur — these practices may in fact be deterrents to confrontational and nonproductive activism. These methods have been utilized in response to adversarial shareholder activism, but they also harken back to a time when the hostile takeover was a common concern to companies. In those days, companies were similarly threatened by the potential of confronting hostile bidders.

Activism can take many forms, and an activist shareholder has several avenues of approach at its disposal, including writing a letter to leadership outlining demands, requesting a meeting with company leadership, orchestrating “withhold the vote” campaigns, initiating proxy contests, and more. Preliminary actions can evolve into stronger actions, including threatening litigation, embarrassing board members, attempting to “divide and conquer” the board and management, and rallying the public shareholders and shareholder representative organizations in support of the activist’s goals.



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While activism has been waged against companies of varying characteristics, there are some qualities that may make a company more likely to attract the attention of activist shareholders, such as an underperforming stock price (relative to market benchmarks and industry peers), perceived misallocation of capital, opacity of executive compensation and company performance, a conglomeration of nonsynergistic businesses, and the undertaking of a controversial extraordinary transaction. The rationale behind activism can vary, but the activist will typically seek changes that it claims will be beneficial to all shareholders.

We briefly state these characteristics as they can be vulnerabilities. Shareholders may see an underperforming stock price as an indicator of a bargain. The activist may seek to improve operations or change management so that the stock price increases. A perceived misallocation of corporate resources may motivate an activist to push for changes in spending, which could result in a slew of outcomes that the activist views as beneficial to stakeholders, including a higher stock price, declaration of dividends, and buy-backs. Similarly, the lack of transparency in executive compensation can fall under a perceived misallocation of funds, and such opacity may arouse feelings of distrust of senior management. Conglomerations of businesses under one company's ownership and operation can be targeted by an activist claiming that shareholders shouldn't have to invest in an amalgam of companies. This is especially true if one or more of the businesses is underperforming and is perceived as dragging down the rest of the company. In such a case, the activist may reason that companies can be separated without affecting the primary business and will liberate value not obtainable if the various businesses are kept together.

In response, companies must have a diverse "tool box" of methods to ensure that they remain prepared to respond. Management and the board of directors should continuously be reviewing their own efforts to increase shareholder value. This primarily involves decision-making and executing on a declared and explained strategy that the company will utilize to respond to the activists. Shareholder activism can lead to positive changes in a company, but it is often short-term oriented and may not fit in with overall long-term company strategy, in which event the activist may become confrontational and unproductive. If successful, increasing shareholder value may be the best deterrent against adversarial activism.

## Specific Demands and Approaches of Activists

### Common Demands Made by Activists:

- Sell a company or division
- Sell the entire company
- Install a new capital structure or reallocate capital
- Suggest that the company pursue different accounting structures (e.g., through tax inversions or sale/leasebacks of real estate)
- Increase dividends or offer special dividends
- Buy back a stake in the company
- Undertake a spin-off of owned businesses to shareholders (e.g., separate businesses through sales)
- Liquidate the company and pay out an extraordinary dividend
- Change management/board structure (e.g., eliminate a staggered board)
- Reform or eliminate shareholder rights plan
- Require majority voting for directors
- Remove or add members to board/management
- Reform compensation packages

- Embark on new strategies
- Reduce costs

## Common Approaches Taken by Activists:

- Request meetings with leadership
- Threaten public action
- Issue open letters “to the board”
  - Appeal to directors using media (including social media such as Twitter)
- Behave aggressively on analyst calls or at shareholder meetings
- Threaten withhold campaigns
- Oppose strategic and/or M&A plans
  - Attempt to force a sale by leaking information or approaching acquirer
  - Offer to buy the company
- Launch short-slate proxy contests
- Initiate proxy fights
- To increase representation on board
- Use financial devices to increase voting power
- Appeal to the shareholder opinion to pressure directors to make changes
- Conduct aggressive “diligence” on board members to publicly embarrass them
- Publicize demands using media (including social media such as Twitter)
- Litigate to prevent company actions or to override company rules

## Preparation — Before the Activist Appears

### Self–Due Diligence

Companies should conduct “self–due diligence” to prepare for activists. Similar in practice to other situations (i.e., for a public offering, merger, or sale), a company should perform a comprehensive appraisal of its value proposition and legal position, including any deficits or vulnerabilities that it may have. Inasmuch as activists target companies that they view as undervalued, conducting self-appraisal can help a company anticipate activism. This self–due diligence exercise should include an understanding of unusual or unexpected developments in metrics, such as financial results and stock performance. Litigation and liability issues can also give rise to activism. Accounting issues and compliance may trigger an approach by an activist. Susceptibility to hackers and the like can also cause problems. Sometimes the activist suggests governance changes as a result.

### Strategy

In line with self–due diligence, the company should conduct an assessment of its operations, as a consultant might do (or possibly with the assistance of a consultant), to get an idea of what an activist might criticize with respect to strategy or operations. The board and management of a company should have regular dialogue discussing the company’s strategy. Possible alternatives should be devised so the company can alter its strategic direction, if deemed appropriate, as a result or in anticipation of shareholder activism. Also, having

already discussed it thoroughly, the board and management will be able to quickly respond to activism with an articulate explanation of the company's strategy.

Company leaders should engage in dialogue and deliberation that focus on shareholders' best interests and be cognizant of areas that may leave the company vulnerable to shareholder activism. Examples of such vulnerabilities include the maintenance of excess cash and the retention of unprofitable businesses owned by the company that could be used to bootstrap the cost of acquiring the company by the activist or a third party.

## Investor Outreach

Ideally, the company should establish and maintain a strong line of communication with both its shareholders and the general public. In particular, the company should be transparent about company operations and communicate frequently with shareholders. Matters to be communicated include overall strategy (including M&A and business operations), executive compensation, perceived risks, and shareholder engagement and process. Larger companies have often experienced positive outcomes as a result of good communication with shareholders in the area of executive compensation. Some companies retain focused PR and IR advisors to facilitate continuous communication with significant shareholders. Management should also take care to communicate with shareholders in a tactful way in anticipation of potential activism. Management should tell its story, emphasizing the reasoning behind strategies that it anticipates may be targeted.

## Review of Constituent Documents

The company's charters and bylaws should be examined to ascertain whether they contain sufficient safeguards to prevent a takeover of the company or other changes to the company's structure without allowing the existing board sufficient time to review the proposals from activists or others.

The charter or bylaws can contain an exclusive forum provision that specifies a particular forum as the only one in which shareholder derivative suits, fiduciary duty claims, and other lawsuits may be brought. While such provisions have been held valid and enforceable, challenges may occur when these provisions are enacted or utilized without shareholder approval. Further, courts of other states than the state of incorporation may not recognize such an exclusive forum-selection provision.

Advance notice provisions for shareholder proposals and director nominations also should be considered if not in place or reconsidered to assure they are optimal if already in place. Limitations could be imposed on the ability of activists to call a shareholder meeting. These and other provisions have become common but may nevertheless attract the ire of activists.

## Test Run

Boards should run a "practice" exercise, in which they internally solicit hypothetical activist campaigns and planned responses. In addition to anticipating activist demands and formulating what changes the company would be willing to make, preparation may include drafting of press releases, letters to shareholders, and other communications plans.

## Action — When Faced with Activists

Even a well-prepared company may encounter confrontational and unproductive shareholder activism. At this juncture, a company is not helpless in protecting itself against such action. Specific steps can be taken to deal with the confrontation. Some companies may decide to consider requests made by activists and may see genuine merit in and adopt suggestions made by activists, "stealing their thunder." Alternatively, there may be times when company leadership decides to reject some or all of the demands of activists and work to defend the company's current strategy and practices.

## Working with the Activist

Activists may have excellent suggestions. For example, it may make sense to follow an activist suggestion to sell or reposition real estate holdings, spin-off a subsidiary, modify compensation, buy a company or dispose of a non-core enterprise.

## Communication and Engagement with Shareholders

Communication and engagement with shareholders and with the activist are the most important tools in managing an activist. Engagement with shareholders at large and with the activist can be used to explain why actions are being taken, the rationale for executive compensation, and similar matters. This engagement can build a relationship with shareholders, which can keep support for company plans if the activist becomes more confrontational and seeks changes that the board believes are not in the long-term best interests of shareholders. Communicating directly with the activist can help the company gain a better understanding of the proposed changes and can be an opportunity for management to explain its own reasoning. Direct communication with the activist may yield a more productive conversation that is less likely to rally aggressive opposition that the company cannot control.

## Valuation and Assessment of Company

Valuation and assessing the company prospects for increased value are important parts of self-due diligence prior to the appearance of an activist, and it is equally if not more important to do once the activist arrives on the scene. An activist may use its own valuation of a company to justify its actions. However, valuations can be subjective and be biased to produce results preferred by the activist. The company, including with the assistance of an outside financial advisor, should engage in valuation exercises to inform its actions without getting boxed into a particular valuation which might limit future action or advocacy of a course of action.

## Defending against the Activist

### Consideration of Adoption of a Shareholder Rights Plan, or So-Called Poison Pill

Many companies work with their outside attorneys and investment bankers to have an “on the shelf” shareholder rights plan ready for the company.<sup>2</sup> The “poison-pill defense” was originally designed to deal with coercive and undervalued hostile bids by company raiders but can be useful in pushing back against activist shareholders. In this scenario, the plan provides that, if a shareholder acquires a stake in the company at or above a company-defined threshold, the company may issue stock at a discount to all other shareholders, thereby diluting the stake of the shareholder who “triggered” the pill. How long and under what circumstances a board can maintain a poison pill in place is fact-specific, but if a board is convincingly continuing to exercise its fiduciary duties in pursuit of the best interests of the company and its shareholders, such period may be lengthy.

### Staggered Board

The institution of a staggered board may help the company keep control of its corporate strategy, and thus, out of the hands of activists pressuring the company’s board to make changes. The structure of a staggered board is such that only a fraction of the board members are elected at each annual meeting, which can help a board substantially maintain its overall continuity and further the pursuit of corporate strategy. It can take several years for shareholders to take over control over a staggered board. A staggered board can be a defense against a takeover through proxy fights, since an activist will have to launch and win several proxy fights to have a significant impact on the board makeup.

### Concerning Proxy Advisory Firms

Proxy advisory firms, such as ISS and Glass Lewis, provide recommendations to their clients on how they should cast votes at shareholder meetings. Such firms have been influential in swaying results in proxy contests,

sometimes more so than at other times. Companies should remain aware of these firms and their positions on governance and other matters. For example, ISS has a policy that it will vote against sitting directors who fail to take action on majority voting proposals.

Many institutional shareholders vote according to an advisory firm's recommendation. Institutional investors that rely on proxy advisor firms may vote according to these firms' recommendations as a matter of practice. This practice may mean that institutional investors vote on their client's behalf, but not necessarily in their best interests.

If proxy advisory recommendations are in conflict with a company's decisions and strategy, leadership should engage with advisory firms to discuss their methods for determining the recommendations. Realistically, the proxy advisory firms can be expected to side with insurgents in most, if not all, cases where only minority representation on a board is sought, on the apparent theory that injection of alternative viewpoints is *per se* good for boards of directors. Nevertheless, a detailed response to the advisory firm might also be useful.

Companies should also try to engage with advisory firms during the off-season to address any misconceptions that may have revealed themselves through the prior vote and discuss issues relevant to the upcoming voting season.

## Continued Communications with Shareholders *and* Activists

Communications made prior to the appearance of an activist should be maintained after the activist appears. Communication should generally be extended to the activist as well as the rest of the shareholders. Continued communication has many purposes. Clear efforts made by the company to respond to activist concerns can help contain frustration that could otherwise build up to more aggressive activism techniques. The communication that was established prior to the appearance of an activist should be capitalized on to garner support for the company's strategic plans.

Communicating directly with the activist is also important. Previously, we discussed engagement with an activist that should take place when a company is open to hearing the activist's suggestions. Here, we discuss the importance of communication in a context where the company has already decided that it will not go along with the activist's proposals. When shareholders approach a board attempting to change governance or with other proposals, they should receive reasoned explanations. The company should ensure that its story has exposure in media and social media. Emphasizing the company's rationale may provide insight to the activist on the benefits of the company's long-term vision.

## Impasse with the Activist

At a certain point, all of the techniques we suggest to limit the influence of activists may fail. Whether it is a shareholder intent on reaping short-term benefits or one who has rallied other shareholders' support for its proposal(s), explanations and communication with the activist may only go so far. The company must consider what concessions it can make while still protecting its core strategy and values. If activists insist that a poison pill must be eliminated, the company may do that but seek to maintain a staggered board, or take other protective actions. The company may also want to consider legal arguments against activist shareholders. The company can explore the activist's compliance with Section 13D regulations, including failure to disclose the purpose of an investment or failure to file a Schedule 13D in a timely manner. The company can consider pursuing its own lawsuit against the activist.

## Insurance

D&O insurance should be reviewed. Some policies include "a demand for nonmonetary relief," in which case defense costs should be covered. Not all policies have this language. Companies should examine both primary and excess policies to determine whether any coverage exclusions could apply and, if so, seek to have these exclusions clarified or eliminated. This is important for when managing requests from shareholder activists.

Companies should stay current on the outcomes of shareholder lawsuits in the industry, including on settlement/judgment terms as well as post-settlement agreements made with insurance companies.

## Common Themes

Majority voting and declassification of boards are two “hot-button” issues that are often supported by shareholder activists. Activists concerned with governance will argue that the lack of majority voting and the maintenance of classified boards diminish accountability. Many large-cap companies have already adopted governance structures that may be perceived as friendly to shareholders, such as destaggered boards, majority voting, special meeting and written consent rights, and simple majority-vote thresholds. As discussed earlier, a company may consider ceding some of its defenses in response to shareholder activists, including its staggered board. If the company chooses to do so, it can enact rules for its newly declassified board, such as barring majority voting on directors.

It is often better for a proxy battle over a director position to result in a “win” for the activist, as it would lead to a new board member with significant and lasting fiduciary duties to the company, rather than a one-off resolution in which the activist does not hold on to responsibility and may continue to target the company without restraint.

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## Endnotes

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<sup>2</sup> Some companies, such as biotechs, may wish to consider such a plan focused on preserving the full use of the company's historical net operating losses and other valuable tax attributes, which can be limited or lost under tax rules due to ownership shifts, but in those cases, the rationale for adoption should be clear and compelling in view of the low and potentially provocative “trigger” necessary in such plans to make them effective under the tax rules for the bona fide preservation of tax attributes.

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