Shareholder Activism Best Practices for Boards

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The roots of shareholder activism can be traced back to the stock market crash of the late 1920's, which was attributed in large part to the lack of corporate transparency in reporting. "Shareholder rights" became a reality with the resulting creation of the SEC, and its enforcement activities ushered in a new age of adherence to rules and regulations.

By the 1970's, social agendas had also begun influencing shareholder actions, with environmental and other interests being championed by investors. The 1980's saw greater focus on how corporations were governed and how executives were compensated, with the formation of the Council for Institutional Investors (CII) by large investors, such as pension funds.

Today, shareholder activists represent a wide range of expressed purposes and demands for change, but the underlying goal of most of them is to increase the return on shareholder investment by advocating actions that the activists believe will lead to an increase in share price. Even the ESG goals expressed by some activists are nonetheless intended to increase company value, even if only in the long term. Of course, there are some activists with purely noneconomic goals, such as to forcing disinvestment from certain countries.

The dynamic through which activists pursue their goals, and to which companies and boards respond, typically creates excess publicity and drama, which is quite intentional on the part of the activists. They are usually committing financial resources provided by investors, such as limited partners, investment funds and others, to whom they understandably wish to demonstrate their effectiveness — that they are making a difference. In contrast, the companies and boards that are

the targets of the activists detest such unwanted publicity since it is, by definition, critical of them and the decisions they have made. This often results in a “circle the wagons” reaction on the part of company targets and their boards, which can be both unhealthy and unhelpful.

The ultimate threat of a shareholder activist is a proxy fight, with the activist challenging the company’s proposed board directors slate, most or all of whom are usually incumbent directors up for reelection. However, a proxy fight can be expensive for both sides, as well as a major distraction for companies and boards, and potentially detrimental to a company’s reputation, its brand acceptance and the stability of its employees. Even the threat of a proxy fight can have an impact, which is why many activist campaigns result in some form of settlement. These campaigns may initially take the form of publicity campaigns, letters to the company and its board (which are made public), shareholder resolutions and consent solicitations, all of which carry an implied threat of a possible proxy fight if no settlement is reached. The timing of activist campaigns typically reflects the company’s annual calendar of board nominations, proxy solicitation and voting during the run-up to the company’s annual meeting, with their accompanying publicity campaigns and the annual meeting itself.

The outcome of an activist campaign might be withdrawal by the activist of its nominations, a settlement with the company that might include changes in board size and/or composition, possible bylaw changes, or a proxy contest with one side or the other prevailing in full or in part.

Interestingly, one often hears in educational programs on corporate governance an admonition that directors should “think like an activist.” In other words, don’t be captured by established ways of looking at the company’s business and its performance, but rather proactively look for possible areas of opportunity and especially make themselves aware of ways in which the company and its board might be subject to criticism by an activist, whether fairly or unfairly.

At the outset of any discussion about corporate governance and shareholder activism, it is important to avoid the common but avoidable bias that boards often experience that the points advanced by a shareholder activist are necessarily wrong. While there are certainly many examples of activists that advocate positions that the board may feel are inconsistent with the long-term value of the company, the board must remember that its fiduciary duty is to all of the shareholders, including any activists. It is certainly possible that the opinions being espoused by an activist have at least some merit.

President Ronald Reagan — possibly quoting President Harry Truman — famously said, “There is no limit to what you can achieve if you don’t care who gets the credit.” Boards should therefore evaluate suggestions and recommendations from any source with an open mind and be on guard for any automatic defensiveness as well as the understandable but avoidable bias that can arise when the board and/or management are the target of criticism.

Activists are often intentionally quite provocative and even personal in their pronouncements that are critical of the company and its board, which can lead to defensiveness. Their objective, after all, is to attract attention, get a response and demonstrate their effectiveness to their investors. So, garden-variety courtesy and politeness may be temporarily on hold.

Directors of a publicly traded company should educate themselves about activism in general and seriously consider making preparations “on a clear day” for an activist campaign, should one arise in the future. This can help avoid an urgent “scramble” to identify, engage and educate needed professionals when an activist campaign arises.

Such preparations might begin with lining up legal counsel in advance. Such counsel should be experienced and knowledgeable about shareholder activism, since it is something of a specialty in corporate securities law. Plus, it is quite possible that the company’s incumbent legal counsel does not have experience with shareholder activism. This does not necessarily mean that the incumbent legal counsel should be replaced, but rather the company’s legal team should be enhanced and strengthened. Legal counsel experienced in activism can help the board identify areas of potential vulnerability or other characteristics of the company and its performance that might attract an activist.

Another potentially useful clear-day action that boards can consider is creating a “shareholder communication policy” for the board. Activists often reach out to all board members individually to lobby them for support. This can result in disorganization and inconsistent information. Instead, the board should decide well in advance of any activist campaigns to appoint one of its members to be the point person for all shareholders — activist or otherwise — who wish to communicate with the board. That board member will be available and responsive to such shareholders and responsible for accurately conveying their input and viewpoints back to the board. Once this policy is adopted, other board members can avoid being accused of being impolite or unresponsive to shareholders who try to contact them, since they can reference the policy whenever they are approached and provide the contact information for the designated board member. A valid justification for such a policy can be that it will prevent possibly inconsistent messages being provided in response to shareholders’ communications, as well as help guard against the improper sharing of material nonpublic information.

Engaging an investor relations firm in advance that is experienced in dealing with activist situations can also be helpful, especially where a company can identify one or more issues that might invite shareholder activism. Such a firm can help prepare possible responses in advance and assist in issuing announcements that might preclude or lessen the impact of activist campaigns, as well as announcements in response to activism. Lining up a qualified and experienced proxy advisor is another action that boards can take, so they will be prepared should a proxy fight be threatened or actually occur.

The boards of all corporations should review their bylaws regularly to make sure they are appropriate for their current reality as well as the foreseeable future. But the boards of publicly held corporations should include in their bylaw review whether any changes might be valuable regarding activism. These could include bylaw provisions covering board composition, board member term length and limits, board tenure, straight versus cumulative voting, universal proxies and shareholder rights plans. While securities legal counsel can help with these questions, having counsel that is especially experienced with shareholder activism can help with these questions in that perspective. The company’s shareholder/investor communications function should be enhanced and reviewed regularly, since having robust shareholder communications may prove especially valuable should an activist campaign occur.

Sean M. Donahue, chair of the public company advisory practice and co-chair of the shareholder activism & takeover practice at the law firm Paul Hastings in Washington, D.C., recommends that public company boards periodically perform a vulnerability and activism assessment. These are performed from a structural perspective, identifying what defenses might be available should they be needed, as well as possible actions to reduce vulnerability. Such actions might be bylaw enhancements to be kept “on the shelf,” like ability to adopt a “poison pill,” which enables legacy shareholders to buy more shares, including at a possible discount, if a corporate takeover is threatened by a shareholder acquiring more than a threshold percentage of the company’s shares.

Shareholder activism will continue to evolve as the investment markets and the regulatory environment change but it is no doubt here to stay. Boards should be sure they are well-prepared for an activist campaign and review their preparation regularly.