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Activist Shareholders in the US: A Changing Landscape

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Editor's Note: The following post comes to us from Stephen F. Arcano, partner concentrating in mergers and acquisitions and other corporate matters at Skadden, Arps, Slate, Meagher & Flom LLP, and is based on a Skadden alert by Mr. Arcano and Richard J. Grossman.

Shareholder activism in the U.S. has increased significantly over the past several years, with activist campaigns increasingly targeting well-known, larger market capitalization companies, such as Apple, Hess, Procter & Gamble and Sony. In 2013, the number, nature and degree of success of these campaigns has garnered the attention of boards of directors, shareholders and the media. While the continued level of success of activists is uncertain, and the longer-term impact of activism is unknown, at the moment shareholder activism is exerting considerable influence in the M&A and corporate governance arenas. In this evolving landscape, public company boards and their managements need to be aware that virtually any company is a potential target for shareholder activism.

Key Factors Influencing the Current Paradigm

Activism has become a viable and increasingly applied (arguably mainstream) tool for shareholders to seek to influence corporate policy. Several changes have occurred over the past few years that have contributed to the heightened — although not universal — success now being enjoyed by activism, including factors related to the activists, institutional investors and corporate defenses.

- ***Greater financial firepower*** —"dry powder" — has become available to activist shareholders, permitting them to make larger and more investments. This increased financial firepower derives to a significant extent from institutional investors that, in seeking "alpha" returns, have turned to activist investor funds as a legitimate alternative asset class.

- ***New activist funds have emerged*** on the scene, including so-called “Son of Activist” funds, or funds started by individuals who previously worked for — and learned their trade from — well-known, successful activists.
- ***Activists have become more sophisticated*** in selecting their platforms and more nuanced in approach, sometimes seeking incremental change and longer-term involvement with target companies rather than solely focusing on short-term gains. They also are running more professional campaigns than in prior years, hiring financial and legal advisors to perform in-depth analyses of target companies, providing written presentations to targets and investors, and seeking more qualified candidates to serve as nominees for the boards of directors of target companies.
- ***Activists have been receiving greater support from traditional long equity investors***. Institutional investors that might not themselves agitate for change are increasingly willing to support activist campaigns rather than simply pursue the path of selling shares of companies they believe are underperforming. Supporting activists has largely lost the stigma that it had among traditional institutional investors, which once may have viewed activists as a disruptive influence acting contrary to the long-term interests of the company, but today view activist investors as a useful tool. In fact, some institutional shareholders are reportedly encouraging activists to agitate at underperforming companies in their portfolio.
- ***There has been a significant increase in media attention to activist situations***. This media attention, often sympathetic to activist platforms, has become another important tool in the activist arsenal, as it is a low cost way to pressure companies.
- ***Large-cap companies have become more vulnerable***. By and large, they have lost their classified boards and shareholder rights plans, often a direct result of corporate governance activist initiatives. Accordingly, they are more exposed to rapid accumulations of shares and contests for board control.

Expanding Activist Agenda

The appearance of an activist has often been a catalyst for M&A or similar activity. One common activist tactic has been to press a target’s board to consider strategic alternatives involving the company, including urging one or more actions, such as sale of the company or significant assets, enhancing dividends, and/or share buy backs, spin-offs or break-ups. Often this tactic has been perceived — and challenged — by targets and others as pursuit of short-term, event-driven gain over longer-term sustained value creation, and this has been the core criticism of activist investors. Without abandoning pursuit of these alternatives in particular situations, some activist shareholders have expanded their agenda to encompass longer term objectives in other situations. Indeed, some have fashioned themselves as “operational activists” who claim they will roll-up their sleeves and help fix under-performing businesses.

Prudent Preparation — Some Key Steps

In view of the uptick in shareholder activism, public companies must remain vigilant to avoid being surprised by an activist accumulation and should be prepared in advance to deal with an activist approach.

- ***Stock watch programs; awareness of activists***. Every public company should have a stock watch program to monitor the trading patterns of the company’s shares, as well as to keep track of ownership reporting on SEC forms. Such a program can help spot unusual trading activity and determine which entities are accumulating stakes in the company. In conjunction with the stock watch program, companies and investor relations departments should be familiar with activist identities and aware of which activists have been active recently with companies in the same industry.
- ***Monitoring all other advance warning sources***. The usual warning signs (13f, 13D, HSR filings and unusual trading volume) are often, but not always, the first indications that an activist investor has taken an interest in a company. Many times, the first indication that an activist is looming is from the activist investor itself via a letter, a revelation made at an investor/activist conference, or attendance on a quarterly earnings call. It’s important to remember that there are significant advantages to activists remaining undetected until they have amassed a significant stake in the company.
- ***Shareholder outreach — in advance***. Companies need to maintain an effective, ongoing shareholder outreach program. The focus should be on where the company stands today and what management’s strategy is for the future, especially as it relates to increasing short- and long-term shareholder value. Ongoing communications with significant shareholders in a manner compliant with Regulation FD help both to ensure that investors understand the company’s story and to provide an important avenue for feedback regarding shareholder views. The strength of the relationship with shareholders and whether shareholders trust management can make all the difference in the world if an activist situation emerges. This trust cannot be built only after an activist shows interest in the company or after a proxy contest has been threatened. Keeping shareholders close, maintaining contact and assessing internal voting and investment processes of institutional investors will help keep shareholder support if an activist situation materializes.
- ***Comprehensive communications planning***. Related to shareholder outreach, companies need to implement a comprehensive communications plan focused not only

on significant institutional investors, but also on the broader market and analyst community. Today, successful defenses against activists are won or lost not with legal defenses, but largely on the success of the communications and investor relations plan. The company will have more credibility among its shareholders if it promotes its strategic plan well before a specific demand is made, as opposed to developing the plan in reaction to a demand from any activist.

- ***Advance formation of a team***. Forming a team before an activist shareholder appears on the scene, comprised of key insider personnel and outside professionals, will serve two critical functions: (a) permitting the company to become educated about shareholder activism in all its facets (and there are many) in a calm atmosphere, and to engage in thoughtful planning regarding how to react should an activist shareholder situation arise, and (b) avoiding what can be costly mistakes (including through delay) in receiving critical, informed advice and making important decisions if and when an activist shareholder surfaces.
- ***Understand critical choices, critical duties and context***. If a proposal from a shareholder activist is received, the target's board and management often will quickly be faced with important threshold decisions, such as whether and, if so, in what manner to meet with and perhaps engage with the activist. Advance exploration of what considerations may be relevant to these decisions (depending, of course, on the nature and specifics of the proposal) can be very valuable to directors and management, including understanding various contextual settings that might apply. For example: Is the proposal public? Is it accompanied by a proposed director election contest? How has the company been performing relative to its peers, operationally and on a stock valuation basis? Have shareholders been frustrated or unhappy with management? What is the make-up of the shareholder base? Equally valuable for the board and management is to have considered in advance both what their duties are — and are not — in the face of an activist initiative, and how the decisions they make in exercising their duties may play out. Given the pressures that activists often seek to apply in particular to the directors of a target company, it seems prudent to provide them with a clear day reminder that they are statutorily vested with the authority and obligation to manage the company.

While almost all public companies are potential targets of shareholder activism in today's world, with advance planning, they can reduce the risk of undetected activist accumulation and be prepared to analyze effectively and deal with shareholder activist proposals. Moreover, if a potential target company has been in dialogue with shareholders and market professionals articulating a credible plan for value creation, it may both reduce the risk of an activist campaign and better position itself to defend that plan if a campaign is launched.