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INSIGHT: Shareholder Activism—Boards Need to Assess Vulnerabilities

By Richard Grossman and Demetrius Warrick March 19, 2019

Skadden Arps attorneys say shareholder activism is here to stay and look at trends for 2019. Taking steps to prepare for activism is critical to help companies effectively engage with activists, and in many instances it can assist companies in driving shareholder value and avoiding activist activity altogether.

Once widely popular only in the United States, shareholder activism has become an accepted strategy across global markets for investors to influence a company's policies and behaviors.

By exercising traditional shareholder rights and utilizing various activist tactics to bring about change, activists are having success even in regions once believed to be either unfriendly to activist shareholders or structurally difficult for activists to execute their strategy.

Traditionally, activist engagement with companies was attributed to a limited subset of activist hedge funds that often engaged with companies in high-profile clashes that made their way to the front page of business newspapers, and typically where such investors were seeking a short-term gain. Though traditional activist hedge funds are still very much in the mix of activist campaigns today, we have seen activist activity broaden, and investors have sought new ways to improve a company's performance and increase shareholder value.

In its 2018 Review of Shareholder Activism, Lazard's Shareholder Advisory Group (Lazard) noted that stalwart activist investors such as Elliott Management and ValueAct invested approximately $4.3 billion and $3.4 billion, respectively, in new activist campaigns in 2018; and nine of the top 10 activists each invested at least $1 billion in new activist campaigns.

As for the rookie statistics, Lazard noted that 2018 also saw a record number of first-time activists launch campaigns.

Global Impact of Activism

Since 2015, there has been a surge in activism activity outside of the United States. Many larger companies in the U.S. have addressed vulnerabilities by updating their corporate governance and capital allocation practices to be in line with market standards.

As a result, activists began to seek new opportunities abroad, in markets where factors such as antiquated corporate governance practices, a general warming to a more shareholder-centric model and the modernization of legal systems have created an environment in which activists are able to deploy their tactics.

Lazard noted that in Europe and the APAC region (Asia, Australia and New Zealand), we witnessed significant activism activity in 2018, as over $20 billion in capital—representing almost a third of the capital deployed in activism activities worldwide—was deployed in Europe and APAC, collectively.

Though we did see the overall level of activism in Europe and APAC decrease in 2018, it's worth noting that in 2017 there were three multi-billion dollar campaigns in Europe alone (Nestle, NXP and Tesco) that drove the dramatic increase in activity in Europe that year.

M&A Activism

Consistent with 2017, M&A-related activism remained a focus for activists in 2018, a trend that is continuing in 2019.

Where no transaction is currently on the table, M&A activism consists of advocating for the sale of a target, consolidation within a specific industry, divestiture of underperforming assets, and breaking a company up into pieces.

In the context of announced transactions, M&A-related activism typically involves either agitating for a higher deal price or blocking a transaction altogether. Lazard indicated that roughly a third of publicly announced activism campaigns were M&A-driven.

High-profile M&A-related activism such as Starboard's ongoing campaign to block Bristol-Myers' acquisition of Celgene illuminates the impact activists can have on the ability of an issuer to execute an M&A transaction.

The proliferation of M&A-related activism has also impacted how bidders and targets engage with respect to potential transactions. In 2018, more than a majority of M&A transactions were initiated by a potential acquirer approaching the target, as opposed to the target initiating a sale process (M&A-Related Developments in Shareholder Activism, The M&A Lawyer, 22 No. 10 M & A Law. NL 4, by Warren S. de Wied, Philip Richter and Gail Weinstein).

Activism has also impacted how target company boards of directors and management teams engage with potential suitors, as they are sensitive to the potential of public backlash if they reject an offer deemed credible. Further, bidders often have a "lever to pull" if they want to increase the pressure on a target to take action in response to a bid, as they know activist shareholders will often have an opinion. [Id]

Board Representation and Composition

Demanding representation on boards continued to be a highly used tactic for activists in 2018. Lazard reported that activists won a record number of board seats (over 160) in 2018, up more than 50 percent from 2017 and approximately 10 percent from 2016.

Further, Lazard noted that only 22 percent of board seats won were through a proxy contest, highlighting that companies prefer to grant activists a board seat (or two) to avoid the public distractions of a timely and costly proxy contest. In many instances, companies were able to negotiate with activists before a campaign went public or before the parties went down the path of a full-blown contest.

It's worth noting that a narrow subset of activists accounted for a significant portion of board seats won. Lazard noted that Starboard, Elliott and Carl Icahn accounted for a material portion of the board seats obtained in 2018; and since 2013, more than half of all board seats won have been won by only 11 activist investors.

We've also witnessed increased focus on director expertise, qualifications and diversity. Key stakeholders and investors, such as the New York City Comptroller (which developed the Boardroom Accountability Project), the state of California (which passed a law requiring that California companies have a minimum number of female board members), and State Street and BlackRock (which voted against companies that lack gender diversity on their boards) have taken actions that attempt to focus issuers on the importance of board expertise, qualifications and diversity.

With this backdrop, activists understand that shareholders (particularly institutional investors) and companies are focused on ensuring that boards are well-qualified, diverse and have the appropriate experience. Nonetheless, activists have not been particularly successful when it comes to nominating women as dissident director candidates, as Lazard indicated that less than 20 percent of activist-sponsored candidates in 2018 were women.

Importance of ESG and New Emphasis on Culture and Purpose

Increasingly, boards of directors and management teams of publicly traded companies need to understand the importance of the environmental, social and governance ("ESG") landscape in which their companies and investors are operating, including the growing prominence of ESG investing as well as a company's environmental and social profile and vulnerabilities.

Though we witnessed a dip in the number of ESG-related shareholder proposals in 2018 as compared to 2017, that difference is largely indicative of certain companies' increasing willingness to engage with shareholders on these issues and collaborate to address their concerns.

In 2018, we saw investors use traditional activist tactics to support an ESG agenda, such as Jana Partners and the California State Teachers' Retirement System's open letter to Apple Inc., in which the investors linked Apple's long-term value to its need to offer parents more tools to protect children and to ensure that young customers use Apple products in an age-appropriate manner. Shortly thereafter, Apple announced that it would introduce new features and tools to assist parents.

Similarly, in 2018, ValueAct's Jeffrey Ubben launched the ValueAct Spring Fund, focused on promoting environmental and social goals for the companies it invests in.

In addition to the increased focus on ESG, institutional investors are now focused on companies' culture and purpose. In 2018, there was a marked increase in the public scrutiny of workplace misconduct, including sexual harassment, inappropriate conduct of senior leadership and unethical behavior.

2019 is sure to find shareholders continuing to focus on improving corporate culture and creating safer and more productive work environments, which they believe will ultimately lead to higher profits. For example, in a recent letter to boards of directors, State Street Global Advisors discussed the importance of corporate culture and set forth a framework to better align culture with ideals. The approach focused on analyzing a firm's relationship between culture and strategy, implementing a process or program to influence and track change, and improving reporting

Similarly, Laurence Fink, CEO of BlackRock, called for issuers to focus on their "purpose" and not just profits. Mr. Fink noted that "when a company truly understands and expresses its purpose, it functions with the focus and strategic discipline that drive long-term profitability. Purpose unifies management, employees and communities. It drives ethical behavior and creates an essential check on actions that go against the best interests of stakeholders."

Many have asked how boards focusing on a corporate purpose and other ESG issues aligns with the well-established duty of the board to take action that promotes shareholder value. Going forward, boards are likely to spend an increasing amount of time discussing the nexus between various ESG issues and long-term shareholder welfare.

Activism Outlook

As we embark on the 2019 proxy season, there are a few items to consider.

Over the past several years, M&A activity has been driven by a resurgent economy and bull market, which has substantially mitigated risk for activist investors. With the political uncertainty going into the 2020 presidential election, unsettled questions on trade and tariffs, and the late 2018 market correction potentially foreshadowing a market downturn, it will be interesting to see how activist shareholders respond to a changing landscape in 2019.

While the initial phase of any economic downturn could create additional opportunities for activists, if any downturn is extended, it may impact activist activity over time. In addition, increased volatility in the markets may create additional opportunities for "short" activists who attempt to profit from an issuer's declining market value.

The proliferation of social media and other easy access outlets as a go-to source for news and information, coupled with the lack of disclosure requirements for short-sellers, creates ample opportunities for short activists to publicize their theses and generate substantial profits.

Activism and Private Equity

Another trend to watch in 2019 is the blurring of the lines between traditional shareholder activism and private equity transactions.

Over the past few years, we have seen Elliott engage in a more traditional private equity strategy, including its acquisition of Gigamon in 2017, its purchase, with Veritas, of Athenahealth in November of 2018 and, most recently, its take-private acquisition, partnering with Siris Capital of Travelport.

Early in 2019, we also saw Starboard step into the quasi-private equity space with its $200 million strategic investment in Papa John's. In certain ways, private equity is a natural next step for activist investors who, in many instances, identify and articulate to the public a company's weaknesses and seek to capitalize on them.

Private equity also increases an activist's own credibility when it makes an approach to a company, as there is the threat that the activist itself can and will make a bid to acquire or significantly invest in the company. However, there are obvious limits on an activist investor's ability to pursue a private equity strategy. First, private equity investors generally have significantly longer capital "lock-ups" than hedge funds, and as such activist hedge funds may need to raise longer-term capital to avoid the potential of limited partner redemptions. Second, it remains to be seen whether larger private equity firms that have the capital needed to acquire businesses will cede ground to activist firms like Starboard and Elliott.

Institutional Investor Influence

In 2019, more attention is being paid to the growing influence of passive investors on corporate elections.

The concentration of equity ownership in public companies by a few institutional investors (e.g., BlackRock, Vanguard and State Street) allows activists (and issuers) to target the shareholders they need to court. As such, both activists and issuers have devoted considerable time and resources to engaging with these key stakeholders.

With this increase in power of the index funds, regulators have begun to take a closer look at the influence of such investors and how they utilize their voting power.

As Securities and Exchange Commission Commissioner Robert J. Jackson Jr. has stated, "we are at a pivotal moment in financial history when corporate elections are increasingly decided by a handful of powerful index fund managers. That concentration of power is an urgent corporate governance challenge of our time. Unfortunately, the SEC's current rules leave investors largely in the dark about how these institutions are voting the shares that underlie American families' savings. That's why I'm here today to call on my colleagues at the SEC to pursue rules that will take advantage of existing data on institutional voting to empower investors with better information as to how their shares are voted in the elections that will determine the future of American capitalism" ("Common Ownership: The Investor Protection Challenge of the 21st Century", Harvard Law School Forum on Corporate Governance and Financial Regulation, Robert J. Jackson Jr, December 14, 2018).

Final Thoughts

Shareholder activism is here to stay and has become an integral tool for certain shareholders to influence issuers. Taking measures to prepare for activism continues to be critical in helping companies effectively engage with activists, and in many instances it can assist companies in driving shareholder value and avoiding activist activity altogether.

Every board of directors and company management team should be advised to "be their own activist" and be proactive in assessing their company's vulnerabilities and identifying areas of potential improvement. More and more companies are regularly reviewing their shareholder engagement strategies to ensure that they have a clear line of communication with key investors and understand their issues and concerns.

Finally, every company should have a "break glass" plan in place in the event an activist investor surfaces, to ensure the company is prepared to respond quickly and effectively, and in a manner that is tailored to the situation.

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