Shareholder Activism Trends in the 2019 Proxy Season

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In 2018, robust U.S. and global M&A activity substantially mitigated the downside risk for activist investors. With political uncertainty ahead of the 2020 presidential election, unsettled questions on trade and tariffs, and the late 2018 market correction potentially foreshadowing a downturn, how activist shareholders respond to a changing landscape in 2019 remains to be seen. Regardless of what happens with the economy and other factors in 2019, recent trends in the industry indicate there are various ways companies and boards can expect to engage with activist investors.

Trends to Watch

Private Equity Approach. A key trend to watch in 2019 is the blurring of the lines between traditional shareholder activism — where investors, typically hedge funds, take an ownership position in a public company and seek to effect material change by utilizing various tactics including proxy contests, stockholder proposals, and public and private agitation — and private equity transactions, where investment firms aim to acquire or take a significant position in private companies (or public companies that they seek to take private) with the goal of exiting in the future at a higher price. Over the past few years, activist investor Elliott Management has engaged in a more traditional private equity strategy, including its acquisition of Gigamon in 2017; its purchase, with Veritas, of Athenahealth in November 2018; and most recently, its take-private acquisition, partnering with Siris Capital, of Travelport. Early in 2019, activist investor Starboard Value stepped into the quasi-private equity space with its $200 million strategic investment in Papa John's.

In certain ways, a private equity strategy 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. The ability to engage in a private equity style investment or acquisition also increases an activist's own credibility when it makes an approach to a company, because the threat exists that the activist itself can and will make a bid to acquire or significantly invest in the company. Thus, an activist investor that approaches a target company with a proven willingness to take a long-term position in a company, or to take a company private, will likely pose a more legitimate threat to public company boards of directors that encounter such a demand.

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, which may require activist hedge funds to raise longer-term capital in these situations to avoid the potential of limited partner redemptions. That, in turn, would require a change in approach to investment strategy that such funds' investor base may not support. 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.

Increase in Power of Index Funds. In 2019, companies are continuing to pay more attention to the growing influence of passive investors on corporate elections. The concentration of equity ownership in public companies by a few institutional investors, including 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.

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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. In a December 2018 testimony at a Federal Trade Commission hearing, Securities and Exchange Commission (SEC) Commissioner Robert J. Jackson Jr. urged his 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."

M&A Activism. M&A-related activism was a focus for activists in 2017 and 2018, and that trend continues in 2019. In situations where no transaction is presently 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. In its 2018 and Q1 2019 Review of Shareholder Activism, Lazard's Shareholder Advisory Group (Lazard) indicated that roughly a third of publicly announced activism campaigns were M&A-driven (*e.g.*, advocating for a transaction, agitating for a higher price or blocking a transaction), and in the first quarter of 2019, 46% of activism campaigns launched had an M&A focus. High-profile M&A-related activism such as Starboard's campaign to block Bristol-Myers Squibb's acquisition of Celgene illuminates the effect activists can have on the ability of an issuer to execute an M&A transaction.

Activism also has changed how target company boards of directors and management teams engage with potential suitors, who are sensitive to the potential for 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.

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 (160) in 2018, up more than 50% from 2017 and approximately 10% from 2016. In addition, in early 2019 we have seen an influx of long-slate nominations, as 10 board change campaigns in the first quarter of 2019 were for 50% or more of the target companies' board seats.

Further, Lazard noted that only 22% 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 time-consuming 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 reported that Starboard, Elliott and Carl Icahn made up a material portion of the board seats obtained in 2018. And since 2013, more than half of all board seats won have gone to just 11 activist investors.

Actions taken by key stakeholders and investors have attempted to focus issuers on the importance of board expertise, qualifications and diversity. For instance, the New York City Comptroller developed the Boardroom Accountability Project, the state of California passed a law requiring that California companies have a minimum number of female board members, and State Street and BlackRock voted against companies that lack gender diversity on their boards.

With these recent developments, activists understand that shareholders (particularly institutional investors) and companies are focused on ensuring that boards are well-qualified and diverse, and have the appropriate experience. Nonetheless, activists have not been particularly successful when it comes to having women candidates appointed to boards, as Lazard indicated that less than 20% of activist-sponsored directors in 2018 were women. By comparison, in 2018, 40% of all new independent directors appointed to boards of directors of S&P 500 companies were women, according to the 2018 U.S. Spencer Stuart Board Index.

ESG and New Emphasis on Culture and Purpose. Increasingly, boards of directors and management teams of publicly traded companies continue to understand the importance of the environmental, social and governance (ESG) landscape in which their companies and investors are operating. Though the number of ESG-related shareholder proposals dipped 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. When ESG-related issues arose in 2018, investors used traditional activist tactics to support their agendas, 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.

In addition to the increased emphasis on ESG, institutional investors now focus on company 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.

In 2019 shareholders likely will continue to focus on improving corporate culture and creating safer and more productive work environments, which they believe will 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, BlackRock CEO Laurence Fink called for issuers to focus on their "purpose" and not just profits. He noted that "when a company truly understands and expresses its purpose, it functions with the focus and strategic discipline that drive long-term profitability."

There is a continuing discussion among the investor community and boards of directors regarding how boards focusing on 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 more time discussing the nexus between various ESG issues and long-term shareholder welfare.

Takeaways

Shareholder activism has become an integral tool for certain shareholders to influence issuers. Taking measures to be prepared 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 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 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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