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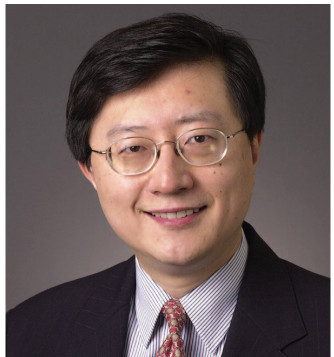
# Forewarned is forearmed

## Shareholder activism requires some agility and some insight



**Closing Argument**

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**Shareholder activism** with respect to public companies continued to grow last year, and there are few indications of this trend abating in the near future.

Activists targeted more than 200 companies in 2014, compared to about 120 in 2010. Activist funds now have more than $200 billion in assets under management, and as a class, they outperformed all other hedge fund strategies in 2014.

Accompanying this strong financial performance has been a remarkable record of success in achieving their governance objectives. For example, activists last year enjoyed a 73 percent success rate in placing their director nominees on targeted company boards, either through full-blown proxy contests or negotiated settlements. In total, activists won 197 board seats and were instrumental in replacing 19 CEOs in 2014.

As the level of activism has grown, and as the tactics employed have become increasingly sophisticated, we have seen an evolution in how companies best prepare for, and respond to, the appearance of activists.

This article summarizes some of these key lessons.

• All activists are not the same. There is, in fact, a broad diversity of shareholder activists. Some are principally concerned with governance or corporate social responsibility matters.

Most of the attention, though, has been focused on "value" activists that seek to promote an M&A transaction (e.g., a sale of the company or a divestiture of a business unit), a greater return of capital to shareholders (through share buybacks or increased dividends) or business and operational improvements (including management changes).

• Boards need to keep an open mind on activist proposals. An activist critique of the company's financial or operating strategy could be constructive in nature.

Because each activist situation should be individually evaluated, it may be unwise to establish detailed advance preparation playbooks that seem to suggest that the board will reject out of hand any overture by an activist.

• Any company could be targeted by an activist campaign. The experience of the last couple of years has taught that even the largest companies in the country can be vulnerable. In 2014, activists targeted 45 companies with a market capitalization of more than $10 billion, including such blue chip companies as Apple, DuPont, eBay, Microsoft and PepsiCo.

Even companies with a generally strong record of financial performance can be targets if they are susceptible to criticism regarding inadequate return of capital to shareholders or the unwillingness to shed underperforming units.

• Structural takeover defenses — designed to address an inadequate or coercive hostile takeover attempt — have proven to be less useful against activists.

To begin with, far fewer companies employ the two most potent structural defenses, the classified board and the shareholder-rights plan. Moreover, while a rights plan may be an important and appropriate response to an activist that seeks to rapidly accumulate a control position in a company, it is not designed to deter a proxy contest and would not be meaningful in situations where the activist is content with holding less than the triggering threshold of the rights plan (such as 10 percent or 15 percent).

Similarly, while the classified board is highly effective in slowing down an outright takeover of the board, a typical activist seeks no more than a one-third representation on the board.

• Proactive and regular engagement with key shareholders has never been more important. Institutional investors are increasingly vocal about how companies are governed and have encouraged companies to engage with them on a regular basis — and not only when an activist situation emerges. Regular communications with key shareholders (and understanding their areas of concern) have always been a good governance practice. It has become vital in an age of activism.

• Anticipate likely activist criticism. Some of the most effective preparatory steps can involve engaging outside advisers to prepare a critique of the company through the eyes of a potential activist. One tactic employed by sophisticated activists is to publicly distribute a detailed "white paper" describing the company's strategic or financial missteps.

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Companies should be prepared to promptly answer the most likely activist criticisms and, on occasion, proactively adopt those responses.

• Regular updates to the board remain a key component of preparedness. Periodic updates to the board on activism should include a general reminder of how directors should respond to an activist, consistent with their fiduciary duties and governance best practices.

More specifically, directors should also understand the degree to which the company is vulnerable to activist critiques and whether it would be appropriate to make any modifications to the company's strategy and operations in light of such weaknesses. ■

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