

Shareholder Activism, Hostile M&A, and Related Issues for the 2021 Proxy Season

Sam Gandhi, Beth Berg, Kai Liekefett, and Derek Zaba
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Sam Gandhi:

It's proxy season. For most companies, a time for annual meetings is just around the bend, and publicly traded companies are coming off a tumultuous year. From COVID to racial justice to worker treatment, the length between the corporation and community has never been more at the forefront, and companies continue to face activist pressure. How should companies navigate this complex environment? We'll find out in today's podcast.

Kai Liekefett:

We had the busiest Q4 of our careers in 2020. We expect much higher number of proxy fights in 2021.

Derek Zaba:

A lot of industries and a lot of companies. Industrials. Consumer. There's a lot of places where activists are going to start to really dig in, and we'll see an elevated level of activism.

Beth Berg:

2020 is a reminder that anything can happen, and it can happen quickly. So, if you don't have a right plan on the shelf, it's time to take that action.

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Sam Gandhi:

From the international law firm, Sidley Austin, this is the Sidley Podcast where we tackle cutting-edge issues in the law and put them in perspective for businesspeople today. I'm Sam Gandhi. Hello, and welcome to this edition of the Sidley Podcast: episode number 17. Part of Sidley's ongoing efforts to help you stay on top of legal developments during the coronavirus crisis. You can find more information in our COVID-19 resource center on Sidley.com. Today, we focus on this year's proxy season and the impact of

COVID-19 in environmental, social, and governance issues or ESG on shareholder activism.

I'm joined by Sidley partners Beth Berg, Kai Liekefett, and Derek Zaba. Beth has more than 18 years of experience in advising companies on shareholder activism, proxy contests, and takeover defense. She also advises companies and boards of directors on M&A, spinoffs, corporate governance, and SEC disclosure matters. She is a partner in the firm's Chicago office.

Kai is a partner in Sidley's New York office and co-chairs the firm's shareholder activism practice. He has 20 years of experience and focuses his practice solely on activism campaigns and proxy fights. In the last five years, Kai's been involved in more than 50 proxy contests, more than any other defense attorney in the country.

Derek Zaba's a partner in the firm's Palo Alto and New York's offices and co-chairs its shareholder activism practice. He counsels clients on activism defense and proxy contests, activism preparedness, takeover defenses, shareholder engagement, and corporate governance, and over the past two decades, he's been involved in dozens of activist campaigns and proxy contests. Beth, Kai, and Derek, thanks for joining me today.

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Beth Berg:

Thanks, Sam. Pleasure to be here.

Derek Zaba:

Thank you, Sam. Thanks for having me on.

Kai Liekefett:

Thank you.

Sam Gandhi:

Kai, we're not quite into the 2021 proxy season yet, but activism is already commenced, and typically, activists are required to nominate directors a few months in advance of their meeting. So, what have you seen so far?

Kai Liekefett:

Well, it's really an interesting dynamic that we see here. Looking back at 2020, obviously, the coronavirus pandemic had a huge impact on last year's proxy season, and since the onset of the crisis was around March of 2020, it more or less killed the entire proxy season last year. Why is that? Well, it's because March is typically the time of the year when activists need to put up or shut up because that's when the nomination windows expire to nominate alternative slate of directors at the annual meeting, and most companies hold the annual meeting between April and June.

So, fast forwarding one year later, the question is, is the pandemic still going to have an impact on the activity for the year for the upcoming proxy season, and what we have seen so far is the following. Starting in about September of last year, a number of our clients got approached privately by activists, and in fact, we had the busiest Q4 of our careers in 2020. A lot of these situations remained private.

Only a handful of them have gone to public fights yet, but there is an enormous activity behind the scenes, and the question, now, that we are facing the next couple of weeks, is how many of these matters will we be able to successfully resolve amicably, and how many of these matters will go to fight. The current indications are such that we expect much higher number of proxy fights in 2021 than last year. Possibly even record levels in the last decade.

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Sam Gandhi:

And Derek, from your perspective, how do you expect activism to unfold this year?

Derek Zaba:

Similar to Kai. I expect it to be very elevated. What we're seeing so far, and frankly, in conversations with our colleagues on the activist side, we've seen more nominations since the beginning of December than we have in quite a long time. It will take some time to determine how they will unfold, and whether they turn into fights or settlements, but we have seen elevated activity so far, and this really isn't unexpected.

If you think about what happened with COVID in the spring versus what happened in 2008, 2009. In 2009, we had the highest number of proxy contests on record, and this relates both to activism and hostile M&A, and during that time period, if you recall, was a long, extended period where a number of hedge funds failed. So, you had extreme carnage in the hedge fund industry and despite that, a significant increase in activism.

Fast forward to here, we have that same level of carnage. We have that same level of changing industries and changing consumer behavior, and yet we have, if anything, more activists. We have seen a number of funds who are on the fringes of activism. Maybe supportive of activists, dipping the toe and becoming activists themselves. So, the number of funds actually interested in pursuing activism is much greater, and you still have the same level of carnage. So, I think that this applies both to this proxy season in going forward, we're expecting a heightened level of activism.

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Sam Gandhi:

Is there a theory that when we're seeing incredible highs in the stock market, that you're not going to see activism, and that only when there's a dip in the stock market do you start seeing more activists?

Derek Zaba:

Well, I think it depends. Markets up as a whole, but it's driven by a few, large, tech firms, and there's plenty of industries and plenty of companies that are still really knocked down, and if you think about the number of proxy contests there are in a given year, there may be between 30 to 50 in the United States. With 4,000 public companies, you don't need a lot of companies that are not performing well in order to increase the level of activism.

So, I think you're right, Sam, that within certain tech companies that are doing really well, it's hard to see an activist approach, but a lot of industries and a lot of companies. Industrials. Consumer. There's a lot of places where activists are going start to really dig in, and we'll see an elevated level of activism.

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Beth Berg:

I'd add to that, that when stock prices are all up and returns are looking good, the underperformers are not as obvious, and it's harder for activists to gain traction with other shareholders, but when there's a market disruption, it often separates out the underperformers, and then, there can be an increased appetite from other shareholders for advocating for change.

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Sam Gandhi:

And Beth, what are you seeing in the M&A world this year?

Beth Berg:

Well, M&A rebounded with a vengeance in the back half of 2020, particularly starting in August, and this trend has continued into 2021. Part of this is the pent-up demand from deals that didn't get done in the first half of last year, but more is fueled by overall confidence now that, you know, we've had developments with respect to vaccines. We have greater political certainty now that the election is behind us, and given expectations about stimulus packages. So you have the high stock prices, abundant PE funds, a low cost of capital, and the topic of this podcast, which is shareholder activism, and all of that has led to a lot more M&A activity, and activists have continued as M&A catalysts.

Even if they don't play a direct role, they often play matchmaker. Whispering into the ears about potential M&A play, whether on the buy-side or on the sell-side or both, and when they do this, there can be increased receptivity to unsolicited offers, and we saw a lot of unsolicited approaches in the back half of 2020, and we expect that to continue. Also, on the M&A front, we've seen a recent pairing of PE and activism, like the joint bid Elliott and Veritas Capital made for Cubic Corp, which was announced early this month, and CoreLogic and Cardtronics are a couple of other companies that were targets of joint PE activist M&A bid.

I think we're only at the beginning of this, and we're going to see much more of this in 2021 and beyond. It's also worth noting that some activists are acting like PE funds, looking to make private investments in public entities or PIPEs. Awash in capital, they need to find more ways to deploy

it, and we expect to see more of this, this year as well. And then, it almost goes without saying that with more M&A activity comes M&A related activism, and in particular, campaigns to break up deals, or at least increase deal prices. So, as M&A activity continues at a robust clip, we'd expect to see M&A related activism rise as well.

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Sam Gandhi:

Derek, we're entering the second year in which we're seeing many public companies hold their annual meetings on a virtual basis. Is the process expected to change in any way this year? Any concerns with how things were handled virtually last year?

Derek Zaba:

Well, I think in 2020, it went amazingly well. If I had told you before the pandemic that there was a technological platform that was fairly nascent, expecting a 10 percent increase and got a 10-fold increase, I think we would all expect there to be a lot of problems and a lot of failures, and the truth is, it went off really, really well. There were a couple of meetings that needed to be rescheduled, but for the vast majority of situations, it actually worked out quite, quite well. There were a couple of, I think, concerns on the shareholder side that the companies had too much control over the questions being asked in certain circumstances, but all in all, it was much better than expected.

I think this year, the expectations will be a bit higher. Last year, companies got a pass. I know Glass Lewis has rescinded some emergency guidance relating to the amount of disclosure you need to provide if you're going to do a virtual-only meeting, and I assess as, similarly indicated that, while virtual meetings this year may be acceptable, I think, going forward, there may be some concerns.

The biggest question, I think, for us, relating to activism is contested meetings. Meetings where there is an activist or a hostile acquirer are much more complex, and the biggest issue there is, typically, there are different ballots. So, there's a different ballot for the acquirer side or for the activist side versus the company, and that creates a whole host of complexity that Kai, Beth, and I spent a lot of time on last spring, planning for and developing contingencies for, and last year we saw a couple of

contested campaigns go to a vote. The difference, though, or the potential issue is those campaigns had hundreds of shareholders.

Hundreds of shareholders are expecting a handful of votes at the annual meeting, and when you're expecting a handful of votes, you can have a system that's pretty much glued together from existing technologies. What happens with one of our mega-cap clients, and we know there are some of our meg-cap clients are under pressure. What happens if you have a company with hundreds of thousands of shareholders? How is the technology going to hold up, and so, we're spending a lot of time, really, trying to bulletproof that in case we find ourselves in one of those situations where a company like that is heading toward a contested vote.

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Sam Gandhi:

Beth, we are nearing the one-year anniversary of a wave of adoptions of shareholder rights plans or poison pills, and we saw that ensuing in the first few months of the pandemic. What sparked that wave, and what do you expect to happen this year?

Beth Berg:

You're right. 2020 did mark the renaissance of the rights plan. More rights plans were adopted last year than in the previous three years combined, but only a third of those adoptions happened in the second half of the year, and I expect this very slow pace to continue. Companies are just not feeling as vulnerable to market volatility and stock drops. So, in large part, the threat that led to all of those adoptions has gone away, but two things linger.

First, the circumstances in 2020 are a reminder that adopting a rights plan may be appropriate even in the absence of a traditional takeover or activist threat. And second, some companies and industries have been particularly hard hit by COVID, and efforts taken to contain it, and those companies may have amassed large NOLs in the last year, which may be a significant corporate asset. Those companies should consider adopting a rights plan to protect against an ownership change under the tax rules and thus, protect those valuable NOLs.

So, in any event, 2020 is a reminder that anything can happen, and it can happen quickly. So, if you don't have a rights plan on the shelf, meaning, it's drafted, and your board has been briefed to a sufficient degree that you wouldn't worry about a duty of care breach if the board had to adopt a rights plan quickly, it's time to take that action. No one regrets being prepared and having a rights plan on the shelf.

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Sam Gandhi:

You're listening to the Sidley Podcast, and we're speaking with Sidley partners Beth Berg, Kai Liekefett, and Derek Zaba about proxy season and the impact of COVID-19 and ESG on shareholder activism. So, let's talk a little bit about environmental, social, and governance issues (or ESG), and how they're shaping during this proxy season.

According to The Sustainable Investments Institute, ESG issues featured prominently in shareholder resolutions filed during 2020 proxy season, and recent grave societal injustices, including the deaths of George Floyd, Breonna Taylor, Ahmaud Arbery at the hands of police officers, have also placed a spotlight on movements such as the Black Lives Matter movement and its core issues, and that's rightly intensified corporate America's focus on justice, diversity, and inclusion.

Nasdaq, for example, recently issued board diversity requirements for companies listed on the exchange, and of course, there's the California 929 regulations that came into play at the end of last year. So, Kai, how do you expect this increased focus to impact what we see in this proxy season?

Kai Liekefett:

There's no question that ESG is one of the hot topics of 2021. It has been a topic on the rise for a number of years now, but the developments that you outlined last year have clearly put it on the top of the issues list for everybody involved in corporate America this year, and if you look at what the proxy advisory firms did, that is quite telling. So, for instance, on more diversity, Glass Lewis now requires a report on racial and on ethnic diversity and requires disclosures to that degree.

Similarly, ISS now will generally recommend against nominating committee chairs at Russell 3000/S&P 1500 boards that elect a female board

member. These are just examples, and there's no question that there will be a high number of shareholder proposals, in particular Rule 14a-8 proposals, this proxy season on the ballot across corporate America. The interesting and related question, however, is, how is this going to impact proxy contests?

That is a different kind of factor. If Carl Icahn, Elliott, or Starboard launches a campaign to replace the incumbent board of directors, will ISS, Glass Lewis, institutional investors, and other constituencies take ESG issues into account when making their voting decision? That is really the big question. What we have heard so far from the proxy advisory firms is that they will continue in these proxy contests to focus on primarily economic issues.

However, they will start taking into account more and more ESG topics, or it is absolutely conceivable that ESG topics may actually tip a close proxy fight one way or the other. In the past, we haven't really seen that in proxy fights. Quite frankly, it was very rare to see activists even to attempt to use ESG topics, in particular, E and S topics in proxy fights. We saw that two or three times to no avail; there's no traction whatsoever in the last several years. But clearly, this is changing, and as everybody knows, there's one campaign already launched that has a primary ESG focus, which is a campaign of an activist against ExxonMobil.

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Sam Gandhi:

Derek, from your perspective, how are shareholders responding?

Derek Zaba:

Well, I think there's one part of ESG, and it's obviously a rubric that carries a broad array of topics, but the one area where we see shareholders responding pretty directly and activists adjusting pretty directly is with respect to board compensation. So, the discussion around diversity, both gender and racial ethnic diversity, is an area that is very directly applicable to proxy contests, which at the end of the day are about board change and board composition.

So, we are seeing activists over the last couple years migrate their slates to be more, have more gender diversity. They have, to a lesser extent, but we can expect this to happen when in greater and greater bulk this year is to

have more racial and ethnic diversity, but even then, they're behind what we see in corporate America. The last that I saw was that about half of new directors in the S&P 500 were women, and about 20 percent had racial or ethnic diversity, and the numbers for activists were about half of that.

So, they're trying to really compete. The flipside is, it's also difficult for activists to target diverse directors. So, if they're trying to replace a female or a racial ethnic diverse director with a white male, especially if there isn't a lot of diversity on the board, that's a very high lift. It's a high bar to do. So, that particular aspect of ESG is more directly impacting proxy contests, and we'll expect that to happen in 2021.

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Sam Gandhi:

President Biden's Clean Energy Revolution plan and other initiatives have brought a lot of these environmental issues to the forefront for businesses just in the last few weeks, and with his appointments of a number of senior officials to climate-focused roles right in the White House, companies can no longer really make big promises for their green initiatives or engage in what they call greenwashing. Derek, how are climate change and sustainability playing a role in shareholder pressures, and how are you advising clients?

Derek Zaba:

We're seeing it more broadly, and this is one of the issues that Kai mentioned that's a little bit more difficult to tie to a proxy contest. So, we've always seen noneconomic issues raise their heads. Governance issues. Compensation. It's easy to tie, you know, board oversight or alleged board oversight failures to a need to change the board and change performance or change management. It's much more difficult to do that with climate change.

We haven't really seen it tied into an activist campaign, really, until this year, but I think it's getting to the point, and I know if it's 2021 or shortly thereafter, that if enough shareholders care about an issue, then demonstrating or a lack of interest in that issue is by itself demonstrating you're not aligned with shareholder interests and so, it's very rapidly going to become something that you need to pay attention to and has economic

consequences. In terms of what we're advising clients, I think that the most important thing is to understand that this is real.

It's here, and it's not going back. We've seen far too many clients that, in the past, have not had enough budget dedicated to these issues. The ROI on investing in these things has not been there in the past, but I can say from this point going forward, it's definitely worth spending some resources in order to make progress.

It's not that you need to be a leader. It's not, you know, you can be a leader. That's great. There are benefits. You can be in the middle of the pack. You can be on even on the edge of the pack, but you have to be in the pack. What you don't want to be is really the laggard that's separated from the pack, and I guess, I'm not sure I should be comparing activists to lions. Maybe jackals is a better comparison, but you're going to get picked off if you are far behind your peers, and so, assessing where you are and spending some money to make sure you're at least in the pack where others are is a well-worth exercise.

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Beth Berg:

I'd just add to what Derek is saying. In terms of how these issues might arise in a proxy fight, most activists really don't care about these issues, and it's the typical economic activist, but they will use these if they think it's advantageous in terms of getting votes of the institution. So, this is just a tool that can be used, and how effective of a tool it is will really depend on your shareholder base, and who is being targeted for the vote, and who matters in your fight.

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Sam Gandhi:

Kai, are there any regulatory reforms worth noting in this upcoming proxy season that's going to change the outlook?

Kai Liekefett:

I don't think there will be an enormous impact on the upcoming proxy season just because we have had an administration change only five minutes ago, and any regulatory changes will take some time. There have been some efforts, though, at the FTC to relax the Hart-Scott-Rodino

notification rules, and for everyone who is not familiar with those, in plain English and a little bit simplified, those rules mean that anyone who acquires estate greater than 92 million dollars in a public company in the United States, needs to give notification to the FTC, DOJ, and the target company.

Now, this places the rule primarily in large-cap activism. In small-cap activism, activists often times stay under this 92-million-dollar threshold, and/or a lot of activists are using derivatives, but there are efforts underway to relax these rules even further, and there has been one very recent development that was interesting. The Biden administration, a few days ago, for the time being, suspended the so-called early termination of the 30-day Hart-Scott-Rodino rule. So, why is it of any relevance? That is of relevance because activists like Elliott sometimes use this mechanism to gently disclose their campaign.

So, how does this work? So, if an activist acquires a stake of 92 million dollars or greater in a company, they need to make that notification to the FTC under the Hart-Scott-Rodino rule, but they can apply for early termination. If early termination is granted, that is actually publicly disclosed on the FTC website. So, you're actually going to see an entry on the website that says, Elliott is hereby cleared to acquire company xyz. It doesn't even say, it's only up to a threshold of 800 million dollars or whatever.

It just says that, and a number of activism beat reporters, including at Bloomberg, are closely following that, and then immediately, create a story around this. So, activists like Elliott have used this tool in the past to disclose their campaign without filing a 13D or public letter; it was just one of those gentle ways to put pressure on target companies, and interestingly enough, if activists do not apply for early termination and then, just wait out the 30-day time period, there's no public disclosure on the FTC website. And so, does it make any sense to you? Join the club. So, that, too, has been taken away recently by the Biden administration.

Couple of other things that are on our radar. Last year, prior to the onset of the pandemic, the Federal Reserve relaxed the rules for the termination of control for the financial institutions in the United States. That actually will have a significant impact on activism. We have not seen it yet because

those rules went into effect only later last year because the Fed decided to delay the effectiveness after the coronavirus crisis erupted, but we all fully expect activists to use the new loopholes in these Fed rules because they will make it significantly easier from a regulatory standpoint to launch a proxy fight against a financial institution.

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Sam Gandhi:

Beth, I'm going to end with a question for you before we wrap up. Is there any lesson to be learned from the 2020 proxy season in key takeaways that clients can use to help prepare for this upcoming proxy season?

Beth Berg:

I would say one key lesson is not to relax. A silver lining of COVID was that there were fewer proxy fights last year, but the activists haven't gone away, and this season seems to be busier than ever, and some activists have said that they're going to be less likely to settle, or least demand more favorable terms to settle, than they have in the past, given that they forewent a lot of fights last year.

So, if you haven't been targeted by an activist, consider yourself lucky, and take steps to position yourself well should an activist surface. There are a few things you can do to do that. First, make sure you know who will be on your advisor team, and make sure you do this before they file a 13D. Second, have someone who's been through proxy contests, like Derek, Kai, or me take a look at your bylaws. There are nearly always improvements that can be made that can be helpful in a fight. Third, as you prepare this year's proxy statement, think about how you're positioning your board.

Do your director bios truly reflect what you think each director brings to the board and think about what else you might highlight that you'd want people to know in a fight, and finally, think about your vulnerabilities. Some, like relative TSR over the last three years, you may not be able to do much about, but others, like, lack of diversity on the board or factors that ISS has called out with red flags in last year's report, are things that you can address now.

Sam Gandhi:

We've been speaking with Sidley partners Beth Berg, Kai Liekefett, and Derek Zaba about the upcoming proxy season and the impact of ESG on shareholder activism. Beth, Kai, and Derek, thanks for sharing your insights.

Beth Berg:

Thanks, Sam. Always a pleasure.

Derek Zaba:

Thank you, Sam. Thanks for having me on.

Kai Liekefett:

Thanks for having us.

Sam Gandhi:

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