

## STANFORD CLOSER LOOK SERIES

# THE EVOLVING BATTLEFRONTS OF SHAREHOLDER ACTIVISM

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## INTRODUCTION

Shareholder activism—the practice of shareholders engaging in a campaign to influence corporate actions—has long been a controversial topic in corporate governance. Supporters of activism view activist investors as important players in the capital markets, holding insiders (board members and management) accountable, imposing efficiency, and mitigating agency problems. Critics view activists as opportunists: shareholders with a short-term horizon who take temporary ownership in a target to push through changes or lobby for a quick sale to realize short-term increases in stock price without regard to long-term value creation.

Shareholder activism has been extensively studied by researchers. Activists tend to target companies with a recent history of stock-price underperformance and poor operating performance relative to peers.<sup>1</sup> They typically accumulate a modest initial ownership position (between 6 and 10 percent), sometimes supplemented with derivatives. Activists are often successful in meeting their stated objectives: Klein and Zur (2009) find they do so more than half the time (60 percent) by compelling their target to repurchase stock, initiate a cash dividend, grant them board representation, alter strategy, terminate a pending acquisition, or agree to a proposed merger.<sup>2</sup>

On average, markets tend to react positively to news of an activist intervention, with target firms exhibiting positive abnormal returns in short trading windows around the announcement.<sup>3</sup> The long-term impacts are less clear. Many studies show positive long-term stock price performance, but only when performance is measured on an equal-weighted basis (i.e., microcap stocks are treated the same as mega-cap stocks) and not on a value-weighted basis (i.e., the total abnormal returns across all activist campaigns is zero).<sup>4</sup> It appears to a significant degree that long-term outperformance is driven by sale of the target. The impact that activism has on operating performance (return on assets, return on equity, and performance relative to peers) is mixed.<sup>5</sup>

Despite the extensive research evidence, there is still much we do not know about activism. This is in part because the nature of activism (its players, their targets, their objectives, their methods) continues to evolve as markets themselves and the regulatory environment evolve. The institutional investor landscape—which determines the ultimate vote outcomes in proxy contests—has undergone a major transformation over the past decade. The rise in power of index funds has lowered barriers to entry for activists and influenced the types of campaigns that are likely to succeed.<sup>6</sup> Additionally, changes in SEC rules, changes in director sophistication, and the adaptation of tactics based on previous campaigns mean that the approaches activists take and their outcomes are not the same as a decade or two ago.

In this Closer Look, we consider current trends in shareholder activism and their potential impact. We examine the introduction of universal proxies, the increase in “activism experience” among directors, and the changing strategies of activists. With the regulatory and market environments in flux, is the balance of power shifting? If so, toward whom?

## 1. UNIVERSAL PROXY

One very powerful tool in the activist repertoire is the ability to forcibly change the composition of the board. Until 2022, activists seeking board representation were generally required to put forward director nominees on a separate proxy card (the dissident proxy card) disseminated to shareholders apart from the company proxy card. From a practical perspective, shareholders making a choice between company and dissident nominees under this system could only vote for candidates from one side: either from the dissident slate or from the company slate, but not both.<sup>7</sup> This process was relatively expensive and cumbersome (with shareholders potentially voting both cards and only votes on the last card received counting).<sup>8</sup> On average, fewer than 50 proxy contests went to a shareholder vote annually in the United States under this regime, while many others settled before the election.<sup>9</sup>

In 2022, the SEC amended proxy solicitation rules to require use of the universal proxy. Under the new regime, company and dissident proxy cards must list both the company's candidates and the dissident's candidates. As a result, shareholders are now able to vote for nominees from either slate with relative ease. This is known as a universal proxy card.<sup>10</sup>

Some of the salient impacts of the universal-proxy rule are well known, such as decreasing the cost of a proxy contest, potentially increasing both the number of contests and the number of funds engaging in contests, potentially increasing the number of (behind-the-scene) threats to gain concessions from a target, and shifting the public debate in a contest from the relative strength of each slate of candidates (and the strategic focus they represent) to a comparison of the merits of individual directors.<sup>11</sup>

Less discussed is whether the universal proxy card regime is likely to increase or decrease board accountability. Minority shareholders have already achieved inroads in recent years encouraging the voluntary adoption of proxy access bylaws, whereby a subset of shareholders meeting specified ownership conditions are allowed to nominate candidates for inclusion on the company's proxy card.<sup>12</sup> The research on proxy access is mixed, with one study showing that *mandatory* proxy access regulations are value decreasing and another finding that *voluntary* proxy access standards are value increasing.<sup>13</sup> In practice, however, the proxy access mechanism has rarely been used, suggesting that the economic impact of adopting proxy access is likely miniscule at best. In any case, the new universal proxy standards expand proxy access to all companies and all shareholder groups, without ownership requirements. Effectively, any shareholder—without regard to size of position, length of holding period, or even economic agenda—has the right to launch a campaign subject to a limited number of requirements. Whether this change increases board accountability or leads to more self-interested or issue-specific activism campaigns is not clear.

The universal proxy card regime is also likely to increase the role and power of proxy advisory firms (such as ISS and Glass Lewis). Historically, due to the nature of the dual-card system, proxy advisory firms have only been required to recommend candidates to support and could be silent regarding which candidates to replace. Under the universal proxy card regime, proxy advisory firms will make recommendations both for and against individual candidates. Investors are likely to respond to this increased complexity by further relying on ISS and Glass Lewis in their evaluation of nominees.

The universal proxy card regime could increase the focus of proxy campaigns of the relative strengths of each candidate. ISS

says of the new rules that boards “will be far less able to shield their weakest contributors.”<sup>14</sup> However, ISS reiterates that its overall approach to evaluating contested proxies will not change. First it will consider “is there a case for change” and, if so, “how much change?”<sup>15</sup> It will then consider factors such as director age, tenure, number of outside board seats, qualifications, diversity of experience, and level of engagement.<sup>16</sup> Whether the proxy advisory firms will be effective in evaluating individual director qualifications based on biographies and extremely limited interactions remains to be seen.

One potential response to the universal proxy card regime is to amend a company's advance notice bylaw provisions. Amendments adopted by companies since the adoption of the universal proxy card rules generally facilitate the purpose of the universal proxy rules (such as providing that dissidents must provide evidence of its compliance with the rules) and sometimes place additional disclosure requirements on the activist investor and their candidates that become more relevant under a universal proxy regime. However, some companies have enacted bylaws that may be viewed as overly burdensome or, from a practical perspective, effectively eliminate the ability for an activist to wage a proxy contest.<sup>17</sup> For example, in 2022, Masimo enacted a bylaw amendment that required shareholders nominating directors to disclose personal information about the investors in their funds. These amendments were subsequently withdrawn. While the courts have not publicly opined on provisions such as those adopted by Masimo, Delaware courts have repeatedly upheld the application of advance notice provisions to disqualify dissident candidates when the dissident has not complied with the bylaws' requirements—including a recent decision that terminated an activist campaign at AIM ImmunoTech that would have used the universal proxy card.<sup>19</sup>

## 2. ACTIVISM EXPERIENCE

Compared to the early 2000s, the number of activist engagements has increased significantly, due to an increase in the number of activist funds and their assets under management (see Exhibit 1 for statistics on activism). One infrequently recognized result is that many more corporate directors have experience with activism today than in years past. As of 2022, nearly 38 percent of directors of Russell 3000 companies have prior experience with an activist campaign, with most experiences occurring in the previous five years.<sup>20</sup> In contrast, in past decades, few board members had knowledge about the legal and shareholder issues associated with activism. Activism is no longer an unfamiliar shock.

As a result, more companies are looking at themselves through

the lens of an activist and proactively taking actions that an activist would advocate (thereby weakening the argument for an activism campaign). Given that activists derive their power from gaining shareholder support, this means companies too are more likely to think in terms of maintaining shareholder support. Companies conduct preparedness exercises and advanced planning to discuss how they would respond, even before an activist engagement takes place.<sup>21</sup> Preparedness also means that boards are much more conversant and comfortable with activism. These practices took a dramatic step forward following the high-profile campaign between Nelson Peltz and Dupont, in which mega-cap companies realized they are not too big to become a target. Preparedness exercises have since proliferated to many large, medium and, in some cases, small-sized firms.

One result of this preparation is that companies have increased their success when campaigns come to a vote. According to statistics from FTI Consulting, whereas the activism slate historically has prevailed 50 percent of the time in a proxy contest, in recent years that success rate declined below 30 percent.<sup>22</sup> Only around 30 directors are replaced each year in contested elections in the United States.<sup>23</sup> How universal proxy rules affect these statistics, however, remains to be seen. Nevertheless, boards no doubt will study early campaigns to gain insight into how to improve their responses.

### 3. CHANGING ACTIVIST STRATEGIES

The strategies activists employ continue to evolve as more enter the market and seek to differentiate themselves. Fewer activists are agitating purely for balance sheet optimization, such as a leveraged recapitalization to fund a large special dividend as a standalone thesis, in part because the large institutional investors that dominate today's shareholder bases are less receptive to this. Instead, funds have evolved their approaches.

One approach is to emphasize strategic and/or operational change as the primary thesis, with the activist asserting that they are expertly qualified to advise on this change as board members. Another approach is to specialize by industry or market niche. Specialization allows the hedge fund to build a track record and reputation within a niche, potentially increasing the force of its argument and at the same time allowing it to better market its services to investors. One example of a specialized activist is Saba Capital, which targets closed-end mutual funds that trade below net asset value.<sup>24</sup> Another is Sarissa Capital, which targets biotech companies.<sup>25</sup> Activists are also increasingly interlacing arguments involving environmental, social and governance factors (ESG) into campaigns by pointing to an insufficient ESG strategy or

unaddressed exposure to ESG risks. Such tactics may emerge from a desire to appeal to institutional shareholders.

Activist funds have also been more willing to target companies previously perceived as “off limits.” One example is utilities, where the presence of strong regulators makes it difficult to agitate for major operating or financial change. Nevertheless, utilities have been targeted by funds such as Elliott Management and Icahn Capital, which have argued for combinations or spinoffs of assets.<sup>26</sup> Furthermore, mega-cap corporations—once considered too large because of their size and the corresponding difficulty of accumulating a sizeable toehold—are now targeted with greater frequency. For example, Softbank was targeted by Elliott Management, despite that fund only accumulating a 3 percent stake.<sup>27</sup> Elliott never aimed to gain control through a proxy contest, but instead lobbied the company to repurchase shares. Similarly, controlled companies are also no longer seen as out of reach, with companies such as Google targeted in recent years—with a thesis of improving efficiency through cost-cutting rather than control through board representation.<sup>28</sup> With so many activists in the industry, we also see multiple funds targeting the same company and not necessarily having the same agenda—a so-called “activist swarm.” For example, Salesforce has attracted involvement by 5 prominent activists within a window of only a few months.<sup>29</sup> Since coordinated voting behavior is even more effective with universal proxy cards, it will be interesting to see whether or how multiple activists coordinate their activities when targeting the same company in the future.

The universal proxy card also makes it easier for traditional governance and ESG activists to make use of director nominations to promote special interests or other non-traditional objectives, similar to how these groups leverage Rule 14a-8 shareholder proposals. Whether these groups will take advantage of this opportunity remains to be seen, but if they do it will open the aperture on the type of companies and directors who are vulnerable to activism since even companies with stellar operational and financial performance could be targeted.

These trends show that the fundamental nature of activism has changed and continues to change. Generating financial returns remains their primary objective, and board representation will likely remain a key tactic because of the control it affords the investor. Nevertheless, activists are broadening their objectives as well as their targets, as they seek to differentiate themselves and generate alpha in an increasingly crowded market. The net benefit to corporate performance remains to be seen.

## WHY THIS MATTERS

1. The adoption of universal proxy is likely to increase the number of activist engagements among public companies. Less discussed is whether an increase in the number of engagements will improve board accountability. Will more boards be held accountable for poor performance or will responsible boards be caught up in unnecessary campaigns that distract them from their core oversight responsibilities or be forced to accept an unreasonable number of activist nominees in order to achieve peace with the activist? Will proxy advisory firms, such as ISS and Glass Lewis, be effective arbiters of board quality when comparing candidates across slates?
2. One unexpected outcome of the increase in shareholder activism in recent decades is a dramatic increase in the number of directors that have previous experience with an activism campaign. How does previous experience change board preparedness? How does it improve dialogue and negotiation with activists? Does it lead to better outcomes? If so, should more boards—particularly underperforming companies—consider adding directors with this experience?
3. An increase in the number of activist funds has forced many funds to embrace new tactics to differentiate themselves: whether it be through the types of arguments, or targeting specific industries and niches, or pursuing targets previously perceived to be off limits because of their size, ownership, or the presence of powerful regulators. Will these changes lead to more thoughtful activism campaigns? ■

<sup>1</sup> Matthew R. Denes, Jonathan M. Karpoff, and Victoria B. McWilliams, “Thirty Years of Shareholder Activism: A Survey of Empirical Research,” *Journal of Corporate Finance* (2016).

<sup>2</sup> April Klein and Emanuel Zur, “Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors,” *Journal of Finance* (2009).

<sup>3</sup> Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas, “Hedge Fund Activism, Corporate Governance, and Firm Performance,” *Journal of Finance* (2008); and Lucian A. Bebchuk, Alon Brav, and Wei Jiang, “The Long-Term Effects of Hedge Fund Activism,” *Columbia Law Review* (2015).

<sup>4</sup> Measuring returns on an equal-weighted basis allows performance characteristics to be compared without regard to the size of the target company, while a value-weighted basis more closely replicates the returns a typical investor might experience with a portfolio that mirrors the general market. To this end, deHaan, Larcker, and McClure (2019) find that the outperformance exhibited on an equal-weighted basis is largely driven by microcap stocks that are trivial to overall stock market performance; most of the excess returns are driven by the smallest 20 percent of firms with an average market value of only \$22 million. See Denes, Karpoff, and McWilliams (2016), *op. cit.*; and Ed deHaan, David F. Larcker, and Charles McClure, “Long-Term Economic Consequences of Hedge Fund Activist Interventions,” *Review of Accounting Studies* (2019).

<sup>5</sup> The market-wide benefits of a strategy of generating alpha through the forced sale of a target is subject to debate. After all, most small- or medium-sized companies could be sold at a premium. That is, they contain an embedded sale option that can be exercised at the appropriate time. Forcing the early exercise of these embedded options results in above-market internal rates of return (IRRs) for activists; but the systemic value is unclear.

<sup>6</sup> Krishnan, Partnoy, and Thomas (2016) document significant variation in the factors associated with hedge fund success. See C.N.V. Krishnan, Frank Partnoy, and Randall S. Thomas, “The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise,” *Journal of Corporate Finance* (2016).

<sup>7</sup> If the dissident had nominated a minority of the board, shareholders voting for the dissident slate could also vote for the company candidates whom the dissident did not oppose. This “short slate” rule disincentivized the nomination of control slates by dissidents.

<sup>8</sup> Nickolay Gantchev, “The Costs of Shareholder Activism: Evidence from a Sequential Decision Model,” *Journal of Financial Economics* (2013).

<sup>9</sup> ISS, “United States: 2022 Meeting Season Review, Director Elections and Governance,” (September 1, 2022).

<sup>10</sup> For a thorough discussion, see Sidley Austin LLP, “SEC Dramatically Changes the Rules for Proxy Contests, Adopts Universal Proxy,” *Shareholder Activism Update* (November 17, 2021).

<sup>11</sup> Sidley Austin LLP, “ISS Provides Guidance on the Universal Proxy Card, Puts ‘Weakest’ Directors on Notice,” *Shareholder Activism Update* (August 24, 2022).

<sup>12</sup> Under a typical proxy access policy, shareholders or coalitions of shareholders who hold 3 percent or more of the company’s shares and who have held their positions continuously for at least three years are eligible to nominate up to 25 percent of the board. Some proxy access bylaws have lower ownership thresholds.

<sup>13</sup> The contradictory results of these studies might be due to the fact that one examines broad-brushed regulation that would apply to all companies, whereas the latter examines situations where proxy access was voluntarily adopted among a subset of companies through a voting process. See David F. Larcker, Gaizka Ormazabal, and Daniel J. Taylor, “The Market Reaction to Corporate Governance Regulation,” *Journal of Financial Economics* (2011); and Reilly S. Steel, “Proxy Access and Optimal Standardization in Corporate Governance: An Empirical Analysis,” *Fordham Journal of Corporate & Financial Law* (2017).

<sup>14</sup> ISS, “The Universal Proxy Card Era Begins,” *ISS Special Situations Research: Research Note* (August 23, 2022).

<sup>15</sup> *Ibid.*

<sup>16</sup> See Sidley Austin LLP (August 24, 2022), *op. cit.* For a summary of the research literature on attributes such as these, see David F. Larcker and Brian Tayan, “Board Composition, Quality, & Turnover” and “Board of Directors: Structure and Consequences,” Stanford Quick Guides Series (2020), available at: <https://www.gsb.stanford.edu/faculty-research/centers-initiatives/cgri/research/quick-guides>.

<sup>17</sup> See Sidley Austin LLP, “Bylaw Amendments, Shareholder Activism, and Flying Close to the Sun,” *Shareholder Activism Update* (November 18, 2022); and Lindsay Frost, “Companies ‘Push the Envelope’ in Universal Proxy Bylaw Amendments,” *Agenda* (October 31, 2022).

<sup>18</sup> See Scott Deveau, “Masimo Investor Politan Sues to Block Activist Rule Changes,” *Bloomberg* (October 21, 2022); and Svea Herbst-Bayliss, “Masimo Reverses Bylaws Requiring Detailed Activist Information,” *Reuters* (February 6, 2023).

<sup>19</sup> *Jonathan Thomas Jorgl v. AIM Immunotech*, No. 2022-0669-LWW, 2022 WL 16543834 (Del. Ch. Oct. 28, 2022). See also *Rosenbaum v. CytoDyn*

Inc., No. CV 2021-0728-JRS, 2021 WL 4775140 (Del. Ch. Oct. 13, 2021) upholding the board's decision to reject nominations made pursuant to nomination notices that lacked all information required under the pre-existing advance notice bylaw).

<sup>20</sup> Data as of September 30, 2022. Specifically, 38 percent of directors experienced an activist campaign in the preceding 20 years. The authors would like to thank Equilar for contributing the data and analysis. Equilar is a corporate leadership data company. See <https://www.equilar.com/>.

<sup>21</sup> Advisory firms such as Spencer Stuart actively sell preparedness services. See Spencer Stuart, "Three Ways Boards Can Prepare for the Upcoming Proxy Season," (December 2023), available at: <https://www.spencerstuart.com/-/media/2023/january/3waysboards/arcl-activismdefense-dec2022-draft3.pdf>.

<sup>22</sup> Note because activism events are fairly few in number per year (50 or less), these numbers can shift from year to year. See Kurt Moeller, "5 Factors Impacting Activists' Declining Success Rate," *The Harvard Law School Corporate Governance Forum* (September 29, 2022).

<sup>23</sup> Insightia, "Shareholder Activism in 2022."

<sup>24</sup> Richard Teitelbaum, "An Activist Saba Takes on Franklin Templeton," *Institutional Investor* (November 15, 2022).

<sup>25</sup> Svea Herbst-Bayliss, "Activist Hedge Fund Sarissa Hires President in Push for Growth," *Reuters* (April 4, 2019).

<sup>26</sup> See Audra Cohen and Tia Barancik, "Shareholder Activism in the Regulated Utility Sector," *Harvard Law School Forum on Corporate Governance* (April 2, 2022).

<sup>27</sup> Jenny Strasburg and Bradley Hope, "Elliott Management Builds More Than \$2.5 Billion Stake in SoftBank," *The Wall Street Journal* (February 6, 2020).

<sup>28</sup> Jon Swartz, "'No One Is Immune': Activist Investors Target Tech Companies After Stocks Dive," *MarketWatch* (February 9, 2023).

<sup>29</sup> Laura Cooper and Lauren Thomas, "Third Point Has a Stake in Salesforce," *The Wall Street Journal* (February 8, 2023).

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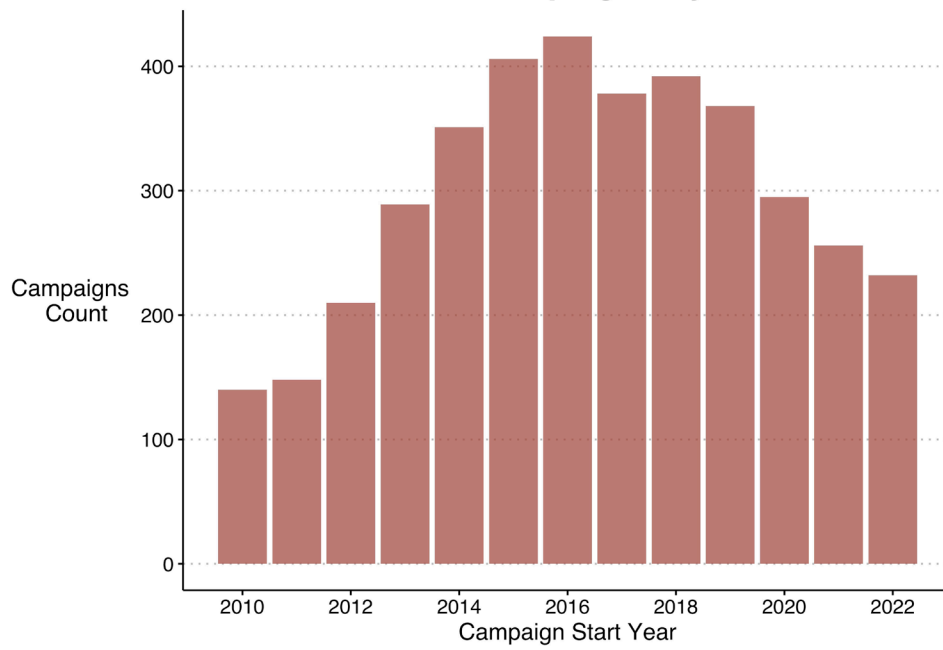
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*The Stanford Closer Look Series* is dedicated to the memory of our colleague Nicholas Donatiello and to the retirement of our colleague Michelle E. Gutman.

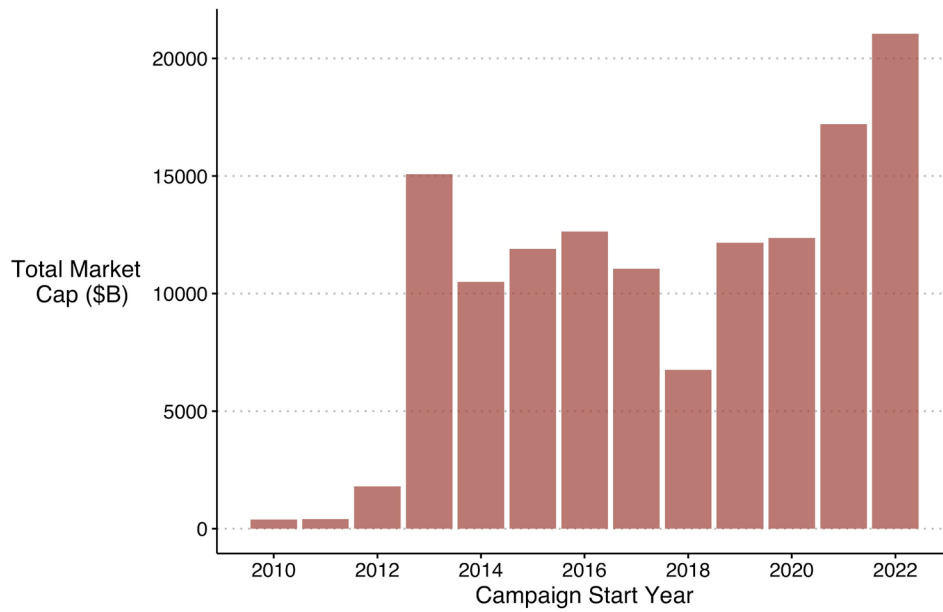
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## EXHIBIT 1 — TRENDS IN SHAREHOLDER ACTIVISM

ACTIVIST CAMPAIGNS BY YEAR

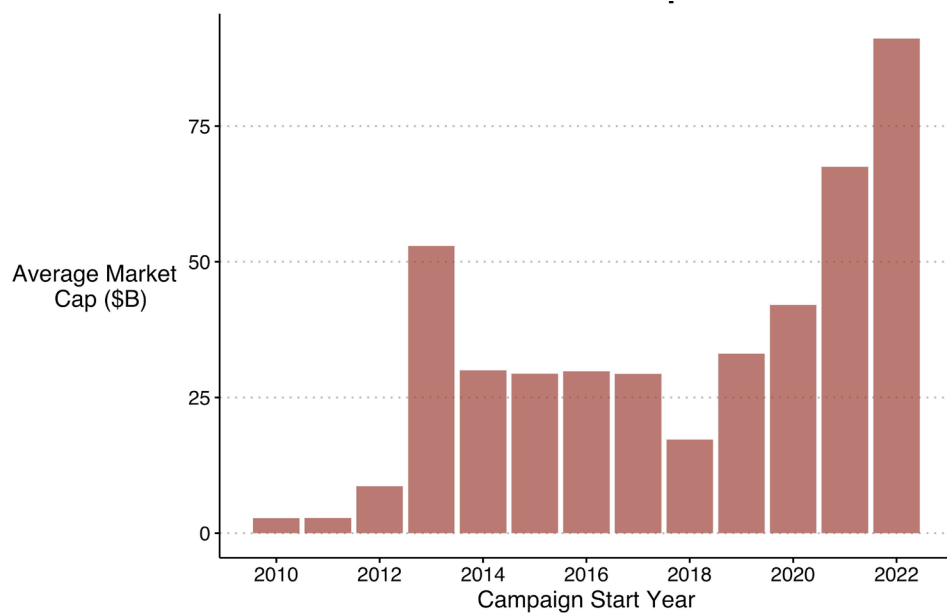


TOTAL MARKET CAPITALIZATION OF AFFECTED COMPANIES

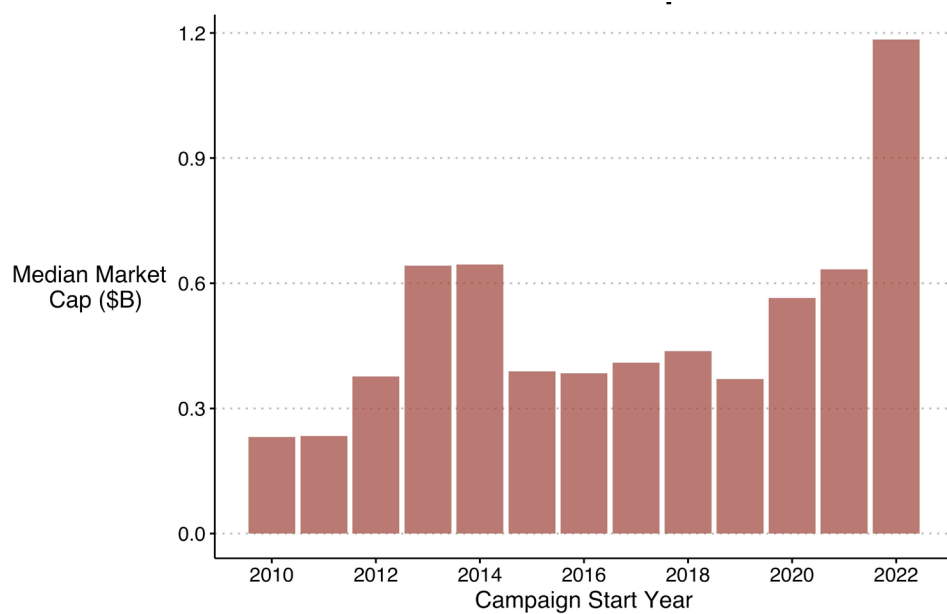


## EXHIBIT 1 — CONTINUED

## AVERAGE MARKET CAPITALIZATION OF AFFECTED COMPANIES



## MEDIAN MARKET CAPITALIZATION OF AFFECTED COMPANIES



Source: Activist Insight.