CORPORATE GOVERNANCE

Preparing for and Responding to Shareholder Activism in 2017

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Activist investors are taking advantage of favorable conditions in the 2017 market environment to further their activist agendas. Activists have an estimated $243 billion in assets under management and are eager to recoup losses from 2016, when the S&P 500 outperformed activist funds as a whole. Companies should review their overall preparedness, take a close look at their potential vulnerabilities to activist attack, and proactively shore up any weaknesses to the extent possible. Anticipating likely avenues of attack will help boards of directors to be prepared and, if necessary, to implement promptly a disciplined and focused plan of response.

Principles of Preparation

Preparation is an ongoing process. Corporate leadership can anticipate an activist approach by evaluating the business through the eyes of a short-term financial investor and understanding how that perspective may differ from that of a long-term, patient investor. Applying an activist investor's mindset to assess and test capital allocation and other strategies for "unlocking value"

can be extremely useful for the board and management team, with the caveat that understanding that mindset does not mean the company should necessarily adopt and implement it. Companies should also remain aware of the takeover landscape in their industry, with an eye to which players may be interested in acquiring them for operational or synergistic reasons, or which may enter the fray if an activist investor puts them "in play."
The core strategy of activist funds is to drive a wedge between the company and its shareholders, or between management and the board. By embarrassing management or the directors, by suggesting that management has not capitalized on available opportunities, or by undermining board confidence in management, the activist creates exploitable weakness in the leadership of the target. Thus, potential target companies need to stay a step ahead and focus on preventing seeds of division from taking root.

Management should keep the board fully informed of their ongoing analysis of likely activist approach tactics. Management should also focus on building and maintaining credibility with shareholders as well as other key stakeholders. While the primary engagement between the company and its institutional investors should be led by management, in some proactive investor relations programs, major institutional shareholders may be afforded the opportunity to engage with independent directors. Such meetings can be very valuable in terms of corporate preparedness, as investors may expose reports of activist activity previously unnoticed by management and may better attune a board to governance and other concerns held by significant institutional investors. In situations where these concerns are unnoticed or not addressed, the activist investor is likely to receive support from frustrated institutional investors.

There are often early warning signs to indicate that an activist approach may be in the offing. Analyst reports suggesting structural changes, extremely pointed questions during a question and answer session on an earnings conference call or during an investor conference, changes in the shareholder base, and activist interest in other industry players are all potential indicators of activist interest. Activist investors are very resourceful and may reach out to investor relations or individual directors before approaching senior management. In these circumstances, all substantive contacts from an activist should be referred to the chief executive, who should be prepared to handle an initial conversation or direct who will handle the initial contact. It can be difficult to walk back statements made during early contacts with an activist, and directors may not have the same perspective (or the same information) as the chief executive.

Principles of Response

It is essential that the company speak with one voice: that of the chief executive, backed by a unified board. The CEO, in consultation with the chairman or lead director, should coordinate the company's response to all activist approaches, overtures, and conversations. Whether or not an activist should be given direct access to the CEO is a tactical decision that should be considered in light of the particular circumstances. While activists may seek to contact board members directly, directors should understand that engaging personally means that their involvement may be publicized, and they should be accordingly circumspect. The CEO should consult with the board and seek advice, with honest and open discussion kept confidential within the boardroom walls. Independent directors can be an important part of the outreach to the activist and institutional investors, but their involvement needs to be carefully choreographed and coordinated. Speaking with a single, consistent voice throughout the activist engagement is essential.

Utilizing advisors well-schooled in activist situations is important. Outside counsel, investment bankers, public relations professionals, proxy solicitors and similarly experienced advisors are important sources of information regarding tactics and approaches for dealing with an activist. These advisors tend to be most useful when they have familiarity with a company before an activist is on the scene but can be useful additions to a team when faced with an activist attack. Directors and management need to remember, though, that most investors want to hear directly from the board and the management team and not have their message filtered by or through advisors. Activists will engage directly with institutional investors, and companies need to do the same.

If at all possible, a company should attempt to keep its discussions with activists private. Once a situation becomes public, the target company's options narrow dramatically. An activist becomes invested in extracting changes for which it can publicly take credit. Moreover, a public situation can create tension with institutional shareholders, who are likely to interpret "long term" as a matter of months and "value" as any amount above their basis in the stock. If an activist approach does become public, the best initial response is simply a statement that the board welcomes, and will consider, input from its shareholders. The board should call a meeting with the management team and consider further communications. Communications outreach may include a press release affirming the board's openness to shareholder input, calls to or meetings with the largest shareholders, outreach to key media contacts, and possibly communications with employees and other important stakeholders. An investor presentation deck should be drafted or updated to reflect the situation and the company's strategy. Each decision made by a company in this context needs to be measured against the standard of whether it is likely to win a vote in support of management or lose a vote to the activist.

While the nature of a company's response must be determined by specific circumstances, constructive engagement is often preferable to taking an antagonistic stance. Many activists will listen to reasonable arguments, particularly in private. They will want to know that their views are being taken seriously and that the board is open to change and willing to consider potential alternatives that are not in the current strategic plan. That said, management and any directors involved should not be too trusting in a "private" discussion. They should act and speak as though anything they do or say will be made public. Conversations, emails, and other communications will be considered fair game for activists to quote, publicize, and use in proxy materials and fight letters opposing management's slate. Moreover, the public dialogue is asymmetrical: Activists will not hesitate to quote a company representative out of context, make personal attacks, and use aggressive language, while the company itself cannot respond in kind. Companies that stoop to the level of the activist will find themselves punished by investors.

Fundamentally, the company must not allow activists to gain the "moral high ground" of corporate governance or shareholder rights. It is the board, and not an activist, that represents the interests of all shareholders. It is the board, in its business judgment, and not an activist, that determines good governance for the company. The board and management should be confident in their leadership and in their judgment and communicate their positions as effectively as possible to the shareholder base. Meanwhile, management must remain focused on the business itself and conduct itself in a manner that preserves credibility and is consistent with the company's stated long-term strategy. The activist situation can create additional challenges, as activists often contact other large shareholders, business partners, institutions, private equity

funds and other potential acquirors, former and current employees, and competitors' shareholders. However, if the company concludes that an activist-sponsored strategy is unwise or counterproductive, management and the board should have courage and confidence in declining to pursue it. Management and the board must then convince shareholders that the company's conclusion is correct.

While an activist situation can seem urgent and fraught, a board does have time and flexibility in responding. The risk of legal liability is low, as long as the board acts in a deliberative manner, on an informed basis. A well-prepared and unified board and management represent a strong bulwark against activist attacks.

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