

C-SUITE

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Risk Issue

Taking on Risk

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The State of Shareholder Activism



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Cited in *The Wall Street Journal* and *The American Lawyer* for his “activist defense” work, Sebastian V. Niles focuses on rapid response shareholder activism & preparedness, takeover defense and corporate governance at Wachtell, Lipton, Rosen & Katz in New York, in addition to M&A and special situations.

He advises worldwide and across industries, and has counseled boards of directors and management teams on self-assessments, engagement with institutional investors and proxy advisory firms and navigating activist situations involving Barry Rosenstein/JANA Partners, Bill Ackman/Pershing Square, Carl Icahn, Daniel Loeb/Third Point, David Einhorn/Greenlight Capital, Glenn Welling/Engaged Capital, Jeff Smith/Starboard Value, Jeffrey Ubben/ValueAct, Jonathan Litt/Land & Buildings, Keith Meister/Corvex, Mick McGuire/Marcato, Nelson Peltz/Trian, Scott Ferguson/Sachem Head, Paul Singer/Elliott Management, Ralph Whitworth-David Batchelder/Relational Investors and Tom Sandell/Sandell Asset Management, among many other activist hedge funds.

In addition to serving as Consulting Editor for the NYSE’s Corporate Governance Guide, Sebastian’s writings have been widely published and he has been a featured speaker at corporate strategy and investor forums like CCMC’s Capital Markets Summit, the Council for Institutional Investors, The Conference Board, Europe’s Activism Rising, the Gabelli Capital Allocation Symposium, the Harvard Law and Business Symposium on Governance and Activist Investing and the Society of Corporate Secretaries.

Sabastian received his law degree from Harvard Law School, where he co-founded the Harvard Association of Law and Business, and his finance, economics and information science degrees from the University of Maryland at College Park, where he won two national championships and four regional championships in intercollegiate trial advocacy.

You and Wachtell Lipton are a recognized leader in corporate law on activism issues, but “shareholder activism” is a broad term. How would you define it, and how does activism manifest?

Sabastian Niles: Shareholder activism used to consist of one-off, isolated approaches that might happen now and again to someone else. Activism now is a permanent environment of scrutiny and potential second-guessing, in which public companies and their long-term strategies may be aggressively targeted and challenged. The challenge is led by sophisticated, well-advised hedge funds, some of whom are laser-focused on boosting the stock price as quickly as possible and by any means necessary, including through escalating pressure and scorched-earth tactics, and others of whom may pursue more constructive, open-minded, behind-the-scenes approaches. I would also distinguish the economic activism sponsored by hedge funds from the governance activism driven by some pension funds, labor unions and other groups. In some cases, that latter kind of activism can inadvertently pave the way for increased vulnerability to hedge fund activism and short-term pressures.

We are in a transformed corporate governance and shareholder engagement environment, in which major institutional investors, mainstream asset managers and even some pension funds are pursuing enhanced stewardship and deep engagement and reducing reliance on proxy advisory firms in sincere furtherance of long-term value creation. On the other hand, there are still many in the financial community who need fast returns and are eager to enlist the “aid” of an activist when their portfolio needs a boost and share “hit lists.”

In this new environment, companies can either lead and adapt from a position of strength or be caught off-guard and flat-footed in the face of an activist challenge.

What kind of demands do economic activists make? Are underperformers more at risk?

Niles: Demands vary, and we often see the “asks” evolve over time or be extreme at the outset, perhaps with the implicit understanding (or hope!) that they might be scaled back in negotiations. Specific objectives can include engineering a sale of the company, a breakup of its businesses (perhaps with the resulting pieces to be separately sold off) or other fundamental restructuring; blocking or sweetening an announced M&A deal; changing capital allocation strategies to boost or accelerate buybacks or other distribution of cash to shareholders, which might be funded by increasing leverage, monetizing company assets or reducing reinvestment in the business; improving margins by cutting costs or capital expenditures; changing the business

strategy or operations; or even replacing the CEO and the Board through a proxy fight or withhold campaign. Companies should also understand more nuanced activist critiques that involve disputes over a company's pacing, priorities or sequencing of business decisions.

As for who gets targeted, some undervaluation in the current stock price (note, I did not say underperformance!) is necessary. But sometimes the better performing a company is, the more vulnerable it is to serious activism.

That's an interesting point, since many public activist campaigns have been positioned as a sort of kick-start for a poorly performing business.

Niles: Each activist and situation is different, and a lot of it depends on the objective in play. It's fashionable to say that activists only target underperformers, but the data and experience shows that's not the case. Ironically, sometimes

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the stronger the stock price and the company's potential, the more the company appears on the screens of sophisticated activists. Surprisingly, doing "too well" can drive long-term supportive shareholders out of the stock when they trade out and remaining investors may conclude that the only way to move the needle further is a sale or breakup of the company. And if a company is performing well, that caps the activist's downside, and if the activist has an approach for increasing the stock price even more, then it's all fair game in their minds.

Empirical studies have shown that the biggest driver of hedge fund profits from activism is forcing a sale and capturing the immediate premium. So with M&A booming and the debt markets attractive, it's no surprise there are cases where there's an extremely strong performer, and

an activist will come in with a hostile bidder wanting to buy the company. Alternatively, where an activist is concerned about an M&A or low interest rate window closing and sees a company in the midst of a turnaround, there may be pressure to sell or lever up and buyback now rather than wait for the strategy to bear fruit. Sometimes a company wonders why an activist suddenly starts pushing for a sale or other immediate action, and it later turns out that the activist was under pressure from its own investors for returns and fending off potential redemption requests.

What is the media's role in contributing to activism? Is this being over-reported?

Niles: The media amplifies activism, sometimes aggressively so, and is not a preferred forum by companies for sober debate and analysis of complex situations. The public dialogue is asymmetrical, with activists becoming personal in their attacks and issuers rightly reluctant to respond in kind. Companies often complain that activists co-opt the financial press, getting both airtime and coverage with a snap of their fingers (or a tweet) and that the press propels activist arguments and attacks without any real pushback or pressure. This media dynamic is one of many reasons why we work with companies to keep activism situations private and out of the public eye to the extent possible. But in fairness, there are reporters who will work constructively with companies and experienced advisors to provide even-handed, merits-based coverage. Smart companies refresh media relationships, prepare statements for potential contingencies and cultivate respected third-party voices who can knowledgeably speak on their behalf, all well in advance of an activist challenge.

In the past few years, it seems that activism campaigns have increased. Is there truth to that perception?

Niles: Yes. I am seeing more aggressive activism of all types in recent years as capital rushes into activist funds in record amounts, filling their war chests, and "wolf packs" assemble against companies. Indeed, activist challenges have accelerated across industries and sectors, at small-caps through mega-caps, from single-product pure-play firms to multinational conglomerates, in developed countries as well as in emerging markets and across company life cycles, hitting newly public companies as well as later-stage growth and long-lived mature businesses. "Next generation" and other new activists are crowding the field alongside well-established funds and sometimes stepping on each other's toes as they hunt for targets. So it's true that no company is too big, too successful, too well-known or even too new to be a target. And the tactics and themes continue to change too.

Given all the activity, shareholder activism is a clear and present business risk and should be dealt with as such. In other words, understand the risk, prevent the risk, and mitigate the risk.

What are some red flags that boards and company management should identify as they evaluate their risk for activist campaigns?

Niles: It's a good question, and companies ask us to review with them our evolving "screening" criteria that activists use, both from an economic and governance standpoint, as well as the key early warning signs. Certainly, if a shareholder or analyst tells you that an activist has been in to see them, that's an obvious flag. So is a warning from a sophisticated stock surveillance and



market intelligence firm of unusual trading activity or that an activist is building a position. Different industries also have unique characteristics to take into account, and companies should be consistently evaluating what hedge funds evaluate, such as absolute and relative valuation, performance against peers and research analysts' perspectives. Activists can be opportunistic and quick to seize upon a temporary moment of vulnerability.

When assessing the takeover and activist environment, look for significant transactions in the industry and activist activity at peers or at companies that could be a potential acquirer or target of yours. We are seeing activists encourage M&A not only by publicly calling for a sale or engaging directly with private equity and strategic counterparties, but also by taking positions on both sides of a potential business combination and trying to forcibly bring the parties together or create a new target to be sold by forcing a breakup. Being an "outlier" without a clear rationale versus peers or the market on key metrics, stock price, capital efficiency or operational and performance measures also attracts attention.

Are there any particular areas that activists are focused on these days?

Niles: In addition to M&A opportunities, heightened scrutiny of business portfolios and cost structures, and discovering "hidden" assets whose value is "waiting to be unlocked," capital allocation and structure is a huge topic in the financial community. "Excess" cash on the balance sheet and conservative leverage ratios are always attractive to activists, and companies that have a lot of cash or strong investment grade credit ratings have to articulate why they are smart to have and keep it, what their strategy is for it and, with respect to credit ratings or low levels of leverage, why they are conservative. Investors are looking for more transparency as to how companies think about deploying capital throughout various cycles, and companies should not take for granted that the market understands the rationale behind the company's choices of what to do or not do.

What about with respect to compensation?

Niles: Would I expect an economic activist without a thesis to attack a company because of a low "say-on-pay" vote or because proxy advisory firms think the newest "best practice" is missing or that compensation practices are "excessive" or "egregious"? No. But can unaddressed executive compensation issues and misperceptions provide pressure points to be opportunistically exploited by activists as "wedge" issues? Certainly. And can well-designed compensation programs that align with long-term strategy, incentivize the right behaviors and use thoughtful targets provide a buffer against claims that a company is mismanaged and poorly governed? Absolutely.

How can boards and executives mitigate risk from potential activist campaigns? Can you walk us through the types of things a company might do?

Niles: Each activist challenge is unique. The issues, tactics, team and approaches will vary depending on the company, the country, the industry, the activist and the substantive business and governance issues at play, among other factors. In all situations, however, there is no substitute for preparation and readiness. Companies should leverage a core team of experienced company-side advisors and study the approaches that have been developed to prepare for and deal effectively with activists. Companies are wise to have "state of the art" practices for:

- Ensuring that the company's board and management receive regular updates on the activist, takeover and governance environment within the industry, understand their duties, implement true "best practices" and are well-positioned to respond and handle an activist situation without making missteps;
- Preparing the CEO and other directors to deal with direct takeover and activist approaches and handling requests by institutional investors and activists to meet directly with senior management and independent directors;
- Conducting an objective self-assessment to identify opportunities for strengthening the company and increasing value for investors and other stakeholders, mitigating potential vulnerabilities and responding to investor concerns, and ensuring that the company's strategy is well-articulated and understood;
- Executing an advance, year-round program of tailored shareholder engagement that reaches portfolio managers, governance teams and proxy voting professionals, involves in select cases director(s) alongside management where appropriate and gives the company a strong sense of investor priorities, perceptions of the company and how investors would evaluate the company and vote in the case of an activist challenge;
- Attracting investors who will support the company's strategies and have investment theses that line up with the board and management's strategic vision and time horizons;
- Anticipating activist tactics and approaches and putting "early warning" systems in place;
- Reviewing the company's governance and structural profile, including the shareholder base, board composition, relevant charter and bylaw provisions, technology that might be kept "on the shelf" (such as a rights plan) and legal developments;
- Staying abreast of emerging governance expectations and norms;
- Engaging with proxy advisory firms and responding to their recommendations;
- Engaging constructively and prudently with an activist and evaluating their views and proposals with the assistance of outside advisors;
- Anticipating public relations and media dynamics in an activist situation, including by refreshing media relationships, preparing statements for potential contingencies and cultivating

respected third-party voices who can knowledgeably speak on the company's behalf;

- Providing compelling evidence of a company's progress and performance and rebutting misleading or incomplete analyses or criticism; and
- Preparing for potential litigation and attempts by the activist to obtain non-public books and records of the company, including board minutes and sensitive analyses.

In our readiness engagements and when counseling clients in live activist defense representations, we review more granular guidance for preparing for or dealing with activist hedge funds.

Any internal controls or procedures for activism that you want to mention here?

Niles: A surprisingly overlooked item is ensuring that the General Counsel/Corporate Secretary's office is kept apprised on a current basis of buy-side and sell-side sentiment, and what investor relations personnel and others at the company who deal with the financial community are hearing. Any questions that indicate a shareholder or an analyst believes there are structural, business or governance changes that would increase value should be brought to the attention of the general counsel, so that a team can decide how best to deal with it, including evaluating what may be in the investor or analyst's mind and how to correct errors or flawed assumptions before they become more widely disseminated. This is especially important with sell-side analysts, as activist hedge funds are increasingly crediting analysts for their ideas. Once a report gets out there and is published, other people are off and running and the issue can become a self-fulfilling prophecy. Good internal communication may be the single most important aspect of this. The investor relations team should also have a robust list of known and occasional "activists" to check against, so that appropriate advice can be given before rather than after the fact for handling activist requests for a call or meeting, understanding with whom they are dealing and managing the discussion effectively without missteps. With respect to shareholder engagement generally, companies need procedures to track—and escalate internally as

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appropriate—messages conveyed, feedback received and follow-up carried out.

What are the most important considerations for boards with respect to shareholder scrutiny and activism?

Niles: First, true readiness is the foundation for a favorable outcome. The board should expect periodic updates on steps the company is taking to maintain a state of preparedness for an activist approach, shareholder perspectives and sentiment, and as to options and alternatives that have been analyzed by management and the company's outside advisors. Failure to prepare for an activist's demands or a takeover bid exposes the board to pressure tactics and reduces the company's ability to control its own destiny. The psychological elements of activist attacks, proxy contests and takeover battles are, in many cases, as significant as the financial, legal and business elements.

Second, Boards and CEOs need to be their own toughest critics. In addition to robust business reviews, meaningful director evaluation is a key expectation of institutional investors, and a corporation is well advised to have it, demonstrate it, and talk to investors about it. However, board trust and confidentiality are crucial, and boardroom debates over business strategy, direction and other matters should be open and vigorous but kept within the boardroom. Activists constantly seek to drive a wedge between the board and the management team and between the company and its stockholders, and board consensus in the event of an attack is extremely important. That means that internal clarity and alignment among the Board and management should be developed before an activist surfaces. Directors must guard against subversion of the responsibilities of the full board by activists or related parties and know to refer all approaches in the first instance to the CEO.

Third, every activist and situation is different, and each board must consider, and regularly revise, its plans and strategies as needed. Intense director involvement in key investor meetings and proxy advisory firm engagements may be necessary as circumstances warrant, and directors are increasingly involved in "peacetime" shareholder engagement efforts too. In a live activist situation, well-advised companies continuously gauge whether or not the best outcome is to make strategic business or other change, perhaps even including recruitment of new director(s) or possible board representation, in order to avoid or resolve a proxy fight. Keeping the board fully apprised of the evolving situation and alternatives and avoiding surprises best positions the company to achieve success, which can include a negotiated resolution where appropriate, on favorable terms. But, after carefully and objectively evaluating an



activist's proposals, boards should be prepared to show backbone if confronted with demands that are ill-advised, misguided or would undermine long-term value or the health of the company.

Lastly, and particularly when in the throes of an activist challenge, boards should help management remain focused on the business and maintain the confidence and morale of employees, partners and other stakeholders. Activist approaches can be all-consuming, but continued strong performance, though not an absolute defense, is one of the best defenses. And when business challenges inevitably arise, opting for candor and acting in a manner that preserves and builds credibility with shareholders and other stakeholders is critical.

Any thoughts specifically from a risk oversight angle?

Niles: From the broader risk oversight perspective, boards are wise to identify external pressures that can push a company to take excessive risks and consider how best to address those pressures. An example would be pressures from certain hedge funds and activist shareholders to produce short-term results, often at the expense of longer-term goals, in ways that might increase a company's risk profile, such as on account of taking on excessive leverage to repurchase shares or payout special dividends or undertaking imprudent spinoffs that leave the resulting companies with inadvisably small capitalizations. While such actions may certainly be right for a specific company under a specific set of circumstances, the board should focus on the risk impact, too, and be ready to resist pressures to take steps that the board determines are not in the company's or shareholders' best interest. No matter how active or activist shareholders may become, directors cannot not outsource their own judgment and must not lose sight of their fundamental fiduciary duties.

I know you represent companies and boards, but do you have any advice for activists?

Niles: I think activists will get better results and earn more respect if they are open-minded about how best to create medium-to-long-term value, avoid grandstanding or worrying about getting special credit, recognize that board and management may have superior information and expertise about the business, and resist the urge to publicly threaten, attack or embarrass a company or its management and board in order to get their way. In many cases, we have had productive engagements and, yes, negotiations with activists where we obtain favorable settlement terms or otherwise help to guide a situation to a mutually beneficial outcome, including many that never become public battles or where the activist concludes they would be better served by moving on to another target or even where, thanks to the company's own initiatives, the board maintaining internal alignment and consensus and the right kind of engagement with shareholders, our client's shareholders encourage the activist to stand down.

How is activism affecting the broader governance landscape and the economy at large?

Niles: Corporate governance changes have made it harder for boards and management teams to discharge their fiduciary duties without undue pressure to

prioritize short-term stock prices. But the pendulum may be shifting, and there's a strengthening view that short-termist pressures on companies are exacerbated by the excesses of shareholder activism and prioritizing shareholder power. Promoting sustainable value creation and making our capital markets attractive to those who wish to thrive as long-term oriented public companies rather than go or stay private are now priorities. A very healthy debate is under way as to whether we have gone too far in increasing shareholder power and moved

Boards should be prepared to show backbone if confronted with demands that are ill-advised, misguided or would undermine long-term value or the health of the company.

too far away from a "retain and invest" corporate mindset to a "downsize and distribute" mentality. For example, a strong consensus of concern has emerged about activist attacks that target R&D investment and innovation, demand excessive risk or cost-cutting at the expense of sustained employment and reinvesting in top-line growth or disrupt well-conceived turnaround plans that simply need time to bear fruit. Although expectations of boards are at an all-time high and will only increase, particularly regarding board renewal, self-assessment and shareholder engagement, mainstream institutions and even some of the most prominent pension funds are increasingly willing to defend and protect boards and management teams from short-termist pressures if they are satisfied with a company's long-term plans and governance practices. In short, we may be moving toward a new paradigm of corporate governance in which major institutional investors abandon rote reliance on proxy advisory firm recommendations, decline to outsource oversight of their portfolios to activist hedge funds and ultimately champion and ally themselves with, rather than against, companies. **CS**