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Dealing with Activist Directors on the Board

With no end in sight to the rapid increase in shareholder activism and activist settlements, companies must be prepared for the new reality of dealing with activists inside the boardroom. This article provides guidance on navigating these complex waters by highlighting the key legal and practical issues that companies and their advisors should consider as they welcome activist directors into their midst.

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The rapid rise of shareholder activism in recent years has brought with it a number of changes to the corporate landscape. Public companies and their advisors have responded by formulating new techniques for engaging with shareholders, rethinking business and governance approaches, developing strategies for working with or fighting activists, and crafting effective settlements.

However, as the success rates of activists continue to grow, with the number of campaigns resulting in board seats almost doubling over the past five years, companies are increasingly finding activist directors inside the boardroom. With this evolution, companies need to develop strategies for dealing not only with activist funds, but also with their extensions inside the boardroom.

This article provides guidance on the key legal and practical issues associated with the presence of activist directors in the boardroom.

This article is based on a resource available on Practical Law. For the complete, online version, which includes additional information on activist directors in the boardroom, as well as examples of a board-level confidentiality policy and board communication guidelines, search Dealing with Activist Directors on the Board.

COLLEGIALITY AND CONFLICTS

Having directors appointed by others is not a new phenomenon. These so-called "blockholder" or "constituency" directors (for example, those appointed by venture capital firms or private equity investors) raise interesting legal issues due to their potential separate interests. Activist directors present many of the same concerns, but also raise other issues due to their often adversarial posture and focus on short-term catalyst events.

Following the election or appointment of an activist director, both sides generally are interested in attempting co-existence. Collegiality is a worthy goal and companies should resist efforts by any director to create an "us-versus-them" mentality. Co-existence generally makes sense for the activist, who usually has only minority board representation and therefore needs allies to push its agenda.

Companies also generally want to give co-existence a good-faith effort, even if the activist campaign was contentious. There may be genuine appreciation for the ideas that the activist brings to the boardroom. Companies are also keen to avoid antagonizing the activist in the hopes of avoiding further hostility or in an attempt to limit aspects of the activist's agenda. While settlements often contain a standstill period during which the activist must refrain from certain control activity, these restrictions often last only for one year or until the next annual meeting.

ACTIVIST INSIDER DIRECTORS AND ACTIVIST OUTSIDER DIRECTORS

The use by activists of "independent" outside candidates in their slates (activist outsider directors) is a significant recent development. According to FactSet and Activist Insight, in 2016 only 27% of activist directors joining corporate boards were activist fund employees or other insiders (activist insider directors), meaning that almost three out of every four activist directors were individuals without significant ties to the activist appointing them.

Companies often distinguish between an activist insider director and an activist outsider director, and take extra care to welcome the latter as true independents. Activist outsider directors often have significant corporate experience and try to maintain a reputation for integrity and independence, even when nominated by activist funds. While recognizing that personal or professional ties, and common views, may exist between an activist outsider director and the activist that recommended them, companies often treat the activist outsider director as independent of the activist to potentially dilute any allegiance to the activist. For example, Elliott Management's recent proxy battle against Arconic Inc. was opposed by the three independent directors placed on the board by Elliott Management in a prior 2016 settlement.

Companies should engage in robust onboarding efforts with new directors, with onsite meetings with management and outside advisors, to ease the transition to the first board or committee meeting. Companies should also consider briefing new directors on any strategic issues before the board. The CEO and lead director should also make extra efforts on a personal, one-on-one level to welcome new directors.

WHOM DO ACTIVIST DIRECTORS SERVE: FIDUCIARY DUTIES

Directors owe fiduciary duties, including the duties of care and loyalty, to the company and all of its shareholders, not just to the shareholder appointing them. In theory, that protects the company from conflicts. In practice, the reality is more nuanced.

While certain close relationships and particular economic arrangements with an activist fund may raise questions of true independence from the activist fund, in most cases activist outsider directors should be treated as owing fiduciary duties exclusively to the company and its shareholders. Activist insider directors, however, may also owe fiduciary duties to the activist fund that appoints them. Nonetheless, an activist director's fiduciary duties to the company and its shareholders are absolute and are not considered diluted by fiduciary duties owed to the activist fund.

Search Fiduciary Duties of the Board of Directors for more on board fiduciary duties, including the duties of care and loyalty.

IDENTIFYING AND NAVIGATING CONFLICTS

Potential conflicting fiduciary duties present issues that boards are increasingly navigating. It sometimes is helpful for the general counsel of the company to maintain an open dialogue with the general counsel of the activist fund, who is often a key ally in mitigating legal risk.

One category of conflicts that arise relates directly to the activist fund (for example, questions relating to enforcement of a settlement agreement, or a transaction with the activist fund or a portfolio company). While activists often push for sales

of companies to third parties, there have been a number of situations where the activist has bid for the company. In these cases, it is important to identify the potential conflict early, because information about potential bidders, and the value of bids, can give the activist bidder an unfair edge. The 2007 bid by ValueAct Capital for Catalina Marketing, on whose board and transaction committee ValueAct served, is a stark reminder of this challenge. One way companies can identify potential conflicts early is by ensuring their codes of conduct require their directors to provide advance notice of any potential conflicts.

Search Model Code of Ethics and Business Conduct for a Public Company for a sample code of conduct requiring directors to pre-clear potential conflicts, with explanatory notes and drafting tips.

Recusal is sometimes also appropriate where the activist director needs to disclose a conflict, but cannot do so without breaching confidentiality obligations to the activist.

The activist fund may also have investments with competitors. In these situations, the company may treat certain company information as commercially sensitive and prefer not to share it with the activist insider director. Both the company and the activist fund should also be aware of potential breaches of the corporate opportunities doctrine, which is intended to prevent directors from taking opportunities that belong to the company.

More nuanced situations that present possible conflicts also increasingly arise, such as where the possibility or threat of a future proxy contest exists and the company wants to consider its options, including with respect to board composition or business operations. Activists, and by extension activist directors, sometimes have short-term investment horizons that present potential conflicts. In a few situations, these timing conflicts have been exacerbated where another portfolio company in the activist's fund is financially distressed and it is motivated to seek liquidity over other goals. These conflicts may also extend to the activist outsider director if the activist director has compensation arrangements with the fund that depend on achieving short-term goals, sometimes known as "golden leashes." Companies should ensure that their advance notice bylaw provisions require disclosure of any potential compensation conflicts.

RECUSAL AND SPECIAL COMMITTEES

Potential conflicts will often be addressed by asking the activist insider director, but rarely the activist outsider director, to recuse himself from board deliberations and voting on these topics. Often, a company's code of conduct will require recusal in conflict situations. Occasionally, where recusal is agreed to in a self-interested activist transaction, the activist director may be given an opportunity to present his views, wearing his "investor hat," before the board deliberates or votes on the topic. If the company allows this, it should document in the minutes that the presentation was invited by the board, which did not deliberate in the presence of the conflicted director.

Recusal is sometimes also appropriate where the activist director needs to disclose a conflict, but cannot do so without breaching confidentiality obligations to the activist. This arises from the potentially conflicting duties faced by these directors. On the one hand, all directors are subject to the duty of candor, which requires disclosure of information to fellow directors. On the other hand, directors may owe a duty of confidentiality to the activist fund that appointed them. In these cases, the conflicted director should announce the existence of a conflict (if possible) and abstain from participation.

Occasionally a director refuses recusal. While state statutes often provide safe harbors for transactions where a majority of the disinterested board approves the transaction and the conflict was disclosed (see 8 Del. C. § 144(a)(1)), courts have expressed concern about failing to exclude interested directors from these deliberations (see *Emerald Partners v. Berlin*, 2003 WL 21003437, at *28 (Del. Ch. 2003); *aff'd* 840 A.2d 641 (Del. 2003)).

If a director opposes recusal, companies have sometimes formed committees to deliberate in the absence of the conflicted director. Delaware courts have explained that a board can exclude a director, whether through a special committee or otherwise, when the director has a conflict with the topic being discussed. The use of committees is a powerful tool because a committee can retain independent legal and financial counsel, and can potentially withhold information from the board (see *Moore Bus. Forms, Inc. v. Cordant Holdings Corp.*, 1996 WL 307444, at *6 (Del. Ch. June 4, 1996)). Occasionally, settlement agreements with activists will limit a company's ability to form a committee to exclude an activist director, although these limits often have negotiated exceptions for certain defined conflicts.

There are many open questions regarding committee use. While Delaware courts have found that the existence of a direct conflict is sufficient to exclude a director through a committee, it is unclear whether the existence of a direct conflict is necessary. Delaware courts have also suggested that companies can restrict a director's access to confidential information without the use of a committee if the director has a conflict (for example, when a director's request for information is motivated by a financial incentive to assist the shareholder that appointed him) (see 8 Del. C. § 220(d) and *Schoon v. Troy Corp.*, 2006 WL

1851481, at *1 (Del. Ch. June 27, 2006)). Whether a Delaware court would use its equitable powers to prohibit a committee that excludes an activist director in a potential conflict situation would likely be a fact-dependent judgment.

Regardless of the approach that companies take to deal with potential conflicts, they should document their steps in the board minutes.

FIRST AMONG EQUALS

One of the challenges facing companies with activist directors is balancing increased pressures by these directors for access to information or personnel and requests for action with the obligation to treat directors equally and preserve the board as a collective decision-making body. Depending on the path the activist took to the board, an activist director may arrive with a perceived mandate to pursue an agenda. Activist insider directors often view themselves as "first among equals" in the boardroom and sometimes other directors feel intimidated and acquiesce in this mindset. At other times, this assertiveness can backfire and lead to an us-versus-them dynamic that results in dysfunction.

Well-advised companies are often able to chart a middle course. There is a practical reality that the activist director will be more active, and will often have the benefit of a team of analysts at the activist fund, that can analyze data and produce information that other directors do not have. However, while leaders do emerge, especially when able to appear more informed, the company should try to create a level playing field to ensure that, as much as possible, each director receives the same information and feels adequately prepared for meetings and decisions.

INFORMATION RIGHTS

Equal treatment among directors is especially important regarding information access. Under Delaware law, except in limited circumstances involving conflict, "[a] director's right to information is 'essentially unfettered in nature'" and all directors are entitled to "equal access to board information" (see *Kalisman v. Friedman*, 2013 WL 1668205, at *3-5 (Del. Ch. Apr. 17, 2013)).

Beyond information presented to the board, Delaware's "books and records" statute also gives directors the right to examine books and records for a purpose "reasonably related to the director's position as a director." The statute imposes the burden on the company of showing why the director should not be permitted to exercise this right, but allows courts to impose conditions prior to a director exercising this right. (See 8 Del. C. § 220(d).)

Companies need to develop a framework for dealing with the increased information and access to personnel requests that often come from activist directors. Companies must consider any potential conflicts that an activist director may have when addressing information requests, because activists often have other investments that may compete with the company. Companies should require that all information requests be routed through a central source, such as the general counsel or the CFO (in some cases the CEO or lead director), and not permit direct phone calls or emails to other executives, unless specifically authorized. Companies sometimes include director access to management in their corporate governance guidelines. These policies should provide that this access must not be unreasonably disruptive to the company, and some companies have also empowered lower-level managers to funnel requests through appropriate channels.

Additionally, companies should make information that is provided to the activist director also available to other directors (either automatically through a board portal, or at the request of any director, following a summary of the information provided). Companies should also consider which items should be presented to all directors at a board meeting, rather than piecemeal by request.

Companies should be mindful of oral information, not just written materials, when making information available to directors. Activist insider directors, or more often a fellow employee of the activist fund, will seek to interview management (for example, finance personnel) at levels far less senior than those typically interacting with the board. While occasionally a company may notify directors of these upcoming calls and invite interested directors to participate, often the pace of these interactions makes this impractical over time. Companies should consider summarizing for directors the scope of diligence that activist insider directors, or their staff, are doing and offering to other directors a similar access program, even if few are likely to take up the offer.

REQUESTS FOR ACTION

Activist directors will often go beyond mere information requests and will actively seek to shape the board's agenda in significant ways. In theory, activist directors risk breaching their fiduciary duties if they advocate for the fund's interests without disclosing related potential conflicts. In practice, activists often make their priorities known in advance of joining the board and argue that they are aligned with other shareholders despite their typically shorter-term holding periods. Both the company and the activist director should understand the need for full disclosure in this area, especially where the activist fund has plans or interests that have not been fully revealed.

Companies should review their governing documents to ensure that a single director is not permitted to call a board meeting. Preferably at least two, and sometimes a majority of directors, should be required to call a special meeting. The activist director may also request to add items to the agenda. Board and committee agendas are typically determined by some combination of the chairperson (or lead director), CEO, and committee chairs, as appropriate. These requests are often granted if reasonable.

Companies also need to review their committee composition and mandates to ensure that an activist director is not able to hijack an important topic with an outsized influence on a committee (for example, a strategic review or transaction committee) compared to the full board. In addition to being sensitive to committee composition, companies need to review non-standing committee mandates to ensure that the authority granted prior to the activist director's arrival is appropriate in light of changes to the composition of the board. In most cases, committee chairs should be identified in the settlement

agreement, with changes approved by the full board, not the committee itself.

Activist directors may make a number of specific requests related to the activist's agenda. Examples include exploration of a sale process or other M&A transaction, replacement of a CEO or other executives, or changes to capital allocation policies, among others. Activist directors may also push to change advisors (arguing for a "fresh perspective" on issues where they may disagree with current strategies), seek to change the composition of the board or committees, or make changes to the company's governance documents. The company, led by the chairman or lead director, needs to be mindful that only the full board is responsible for taking these actions, regardless of the intensity of feelings of the activist director or the size of the claimed mandate from shareholders.

CONFIDENTIALITY

An important concern for companies with activist directors is the risk of disclosing sensitive company information, including both substantive company information (such as financial or operating measures) and board deliberations on important topics. An example of the former is the 2006 public leak about Hewlett-Packard's strategy, later revealed to have originated with a director, who ultimately resigned from the board. An example of the latter occurred in 2013, when Bill Ackman of Pershing Square, an 18% owner and director of JCPenney, publicly released two letters to fellow directors publicizing an internal board dispute. The growing dysfunction and disagreement over policy led to Bill Ackman's resignation from the board.

Courts infer an obligation to keep material corporate information confidential from the general fiduciary duty of loyalty (see *Shocking Techs., Inc. v. Michael*, 2012 WL 4482838 (Del. Ch. Oct. 1, 2012), *vacated for failure to prosecute*, 2015 WL 3455210 (Del. Ch. May 29, 2015)). Significantly, duty of loyalty violations create risk of personal director liability that is not subject to indemnification or exculpation by the company (see 8 Del. C. § 102(b)(7)), even though the activist fund may choose to indemnify the activist insider director.

Many companies are also adopting board confidentiality policies (see below *Confidentiality Policies*). While an activist director may take the view that his fiduciary duties require public disclosure, Delaware courts will likely be skeptical of these arguments, especially where the director acts in contravention of the company's confidentiality policies and without authorization. Companies should consider having an attorney, preferably outside counsel, give a primer on board confidentiality to all directors periodically, and in particular when an activist joins the board.

In recent years, attorneys and judges have considered whether activist directors can share confidential information with the activist fund that appointed them. The desire to share information stems from several practical considerations. For example, sometimes the senior activist is not on the board but appoints one of his colleagues and expects to be briefed. Even if the senior activist is on the board himself, he almost always shares information with colleagues to help monitor the investment.

In a recent decision, Vice Chancellor Laster stated that activist insider directors do not breach their fiduciary duties when they share confidential information with the activist fund that appointed them because if "the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director" (*Kalisman*, 2013 WL 1668205, at *6). While some believe this is too broad, in any event this right is not unfettered and should not apply where there is potential conflict. Vice Chancellor Laster has also held that a shareholder-affiliated director may breach his fiduciary duties "depend[ing] on what the provider and recipients do with the information, including whether they use the information to the detriment of the corporation and its stockholders or to benefit themselves improperly" (*In re Dole Food Co., Inc. S'holder Litig.*, 2015 WL 5052214, at *43 (Del. Ch. Aug. 27, 2015)).

Most companies and activists choose to eliminate the uncertainty of these issues contractually, by entering into a separate confidentiality agreement with the activist fund, along with the settlement agreement. These agreements with activist funds generally provide that the activist insider director may share information with the appointing fund, but the fund agrees

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to keep the information confidential from third parties (including employees not working on that investment), and use it only for purposes of evaluating its investment in that company. The latter use restriction is particularly important to ensure that competitively sensitive information is not used for improper purposes, such as investments in competitors.

One question that remains unanswered is whether an activist insider director who wins election through a proxy contest, and not by a settlement agreement, should be entitled to share any information with the activist fund. Uncertainty regarding this issue is one point of leverage that some companies cite when negotiating with activists, arguing that obtaining a clear right for the activist director to share information with the activist fund is one benefit of settlement. However, as a practical matter, once an activist director is elected, both sides may decide to enter into a confidentiality agreement with the fund, considering the mandate from shareholders and the need to limit risks around information sharing.

Companies and activist funds also need to consider the federal securities laws regarding disclosure of confidential information or trading by the activist fund. The activist fund and activist director may face insider trading liability if the fund trades on material non-public information. Companies generally treat an activist fund that has appointed an insider to the board as an insider for purposes of its insider trading restrictions and may require pre-clearance and compliance with "blackout" periods.

BOARD POLICIES

Companies should periodically review their board policies, including those contained in codes of conduct and corporate governance guidelines, especially prior to the arrival of an activist director. Companies may need to reconcile broad prohibitions contained in board policies with the particular settlement agreement with an activist fund.

CONFIDENTIALITY POLICIES

Companies are increasingly adopting board confidentiality policies, either as standalone policies or as part of broader conduct or governance codes. While these board policies generally apply to all directors, it may be advisable to have each board nominee agree to the confidentiality policy, through an undertaking or even a bylaw requirement. If there is a settlement agreement with the activist, it will often require its nominees to abide by board policies (at a minimum, those in effect and made public as of settlement).

Confidentiality policies should define confidential information broadly to include all non-public information that the director learns through board membership, and should clearly express that the policy covers both confidential company information, such as financial and operating information or trade secrets, and confidential board information, such as discussions and deliberations of the board. The confidentiality policy could provide examples of the types of information covered and, in some cases, also specifically address the sharing of information by an activist director with their appointing activist fund.

SPEAKING WITH ONE VOICE

Activist funds that seek election to a company's board will often have established close relationships with, and sometimes garnered strong support from, other shareholders, as they publicly push for a change agenda. There is a temptation to continue this dialogue, as well as engage in dialogue with the media and sell-side analysts, even when an activist director joins the board, in an effort to influence company actions beyond board membership. At other times, activists may reach out to potential acquirors of the company to entice them to act. This temptation needs to be treated with great caution.

Companies need to remind directors that they should not individually speak to investors, analysts, the media, or others on behalf of the company, unless specifically authorized to do so by the board, and that doing so could embarrass the company, create a perception of divisions, and lead to violations of federal securities laws (including Regulation FD) and fiduciary duties. Companies should consider asking the activist fund to pre-clear, or at least share in advance, the information it shares with its own limited partners about the company. In addition to having counsel remind directors of these obligations and the need to speak with a single voice, some companies have also adopted policies that specifically prohibit such unauthorized behavior.

Board policies serve to educate and advise activist directors and activist funds about board member obligations. One additional benefit is that these policies create a strong record for potential litigation, including in a case against an activist director for breach of fiduciary duties. However, enforcement of violations of board policies can present challenges because they are generally not self-executing.

Settlement agreements sometimes require the activist director to sign an advance resignation letter that would be effective upon the director's violation of a policy. However, activists disfavor these provisions, in part because disagreements over violations and enforcement make automatic consequences risky. Both sides may prefer to avoid a damaging public fight or litigation about the validity and fairness of the company's internal process for making the breach determination.

Alternatively, a board could adopt a bylaw that prevents a director who breached the confidentiality policy from serving as a director in future years, although similar enforcement issues would arise. In practice, boards can wait and decline to re-nominate a director who materially breaches a board policy. In some cases, the company may threaten to publicly expose the issue or even bring a lawsuit if the activist director, or the activist fund, refuses to accept the decision.

Search Dealing with Activist Directors on the Board for the complete, online version of this resource, which includes examples of a board confidentiality policy and board communication guidelines.

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