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# ‘Be your own activist’ – avoiding common pitfalls in activism preparedness

BY ELINA TETELBAUM

Public companies are well-advised to ‘be your own activist’. Many companies across the US – and increasingly, the world – are regularly conducting activism vulnerability assessments on themselves, including assessments of issues an activist may raise, in order to preempt and deter activism.

In the current climate of shareholder expectations, it is essential for a company’s management team and board to regularly review the organisation’s business strategy, portfolio and governance – which can help

explain its business direction and leave the company better positioned in the face of an activist attack.

Importantly, however, being ‘your own activist’ can run the risk of importing short-term thinking into the boardroom. Vulnerability assessments are intended to arm officers and directors with insights about the levers at the company’s disposal to drive shareholder value – but many of the ideas an activist might raise come with significant risk and may be better left to a future day or may simply make no sense for the company at all.

This article lays out key areas of activist focus – including increased capital return, portfolio simplification, operational improvement, sale of the company and governance changes – and provides a roadmap for sensibly evaluating vulnerability while avoiding the pitfalls of short-termism.

## **Increased capital return**

A common activist critique is that a company is failing to properly and sufficiently return capital for the benefit of shareholders. Activists often make demands for

a company to increase dividends and share repurchases significantly, which often provides a bump in stock price in the short term. Companies subject to this criticism find themselves having to articulate why reinvesting in the business is a better use of capital than simply returning it to shareholders.

Vulnerability assessments on capital return involve the company comparing its capital return history to that of peers in the industry, as well as an evaluation of the company's internal capital needs and the relative value of capital investment versus capital return. The company may enlist the help of a financial adviser for this evaluation. For example, a company might look at the percentage of free cash flow that is returned to shareholders versus a peer median. It is often helpful to communicate to the market targeted levels of capital return, and ground those targets within the strategic and operational priorities of the business.

There is no 'one size fits all' approach to capital return. A company should evaluate its capital return targets in the context of any near-term opportunities for investment that would have to be foregone if more capital was returned. Capital return should also be evaluated in the context of the leverage profile of the company, taking into account near-term maturities. Operating a sustainable business for the long-term benefit of shareholders involves making capital investments, seizing M&A opportunities and paying for talent.

Capital return objectives should be balanced against growth priorities.

### **Portfolio simplification**

Activists often say that a company would be worth more to shareholders broken apart than kept together. Activists commonly make demands for a company to divest or spin-off 'underperforming' or 'undervalued' business lines or assets, or otherwise simplify the portfolio mix. Companies subject to this criticism find themselves having to articulate why the business conducted is more valuable than the sum of its parts.

Vulnerability assessments on 'portfolio simplification' arguments involve the company performing sum-of-the-parts analyses on its business, and understanding candidates for divestiture that might be accretive to growth or margins. As part of its ongoing strategic planning, a company may decide that a divestiture or portfolio realignment is the right choice for the company.

And where the decision is that divestitures do not make sense, it may be helpful to communicate to the market the benefits of an integrated business and how the portfolio mix drives growth and cost savings at the company. Staying updated on how industry peers are reorienting portfolios is also useful in staying ahead of potential attack vectors.

Undertaking separations or divestitures often comes with breakup costs, dis-synergies and execution risk. Although activists

often profit from announcements that a company may be exploring a divestiture or breakup, the long-term shareholders are the ones that lose value in a failed deal process or if a company sells a crown jewel at the wrong time. Excel maths is not a substitute for business judgment.

### **Operational improvement**

A company is underperforming because the management team is not effectively operating the business is another common activist critique. Activists commonly make demands for a company to improve operating margins, whether by growing top line revenues or reducing expenses.

Some activists expressly call for a change in chief executive as a way to drive operational improvement, at times proposing a different candidate or calling for the board to announce a chief executive search process. Other times activists may point out a lack of industry expertise on the board as a reason that the board is unable to hold management accountable for operational weakness.

Vulnerability assessments on 'operational' arguments involve the management team working with its board to take a hard look at the drivers of growth and the company's place in the competitive landscape. Also core to the exercise is reviewing the company's compensation programmes, at the executive level and throughout the organisation, and making sure the right bench is in place to drive operational excellence.



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In the normal course of succession planning, boards would also be well advised to maintain a pipeline of potential directors with industry expertise that could enhance the board’s ability to oversee the business and avoid foreseeable operational crises.

Every company can find ways to drive short-term shareholder value but at the cost of the company’s values that are important to long-term business success. What an activist may characterise as ‘operational bloat’ may be a company’s concerted strategy to treat employees well and promote retention in a competitive labour market.

Activist investment time horizons generally are not long enough for true turnaround efforts: boards should be prepared for how quickly an operational attack vector morphs into the activist’s true objective of a full company sale. Great care should be taken before publicly committing to various operational targets, as doing so to appease an activist may make it harder to retain credibility and shareholder support if aggressive targets fail to be achieved.

### **Sale of the company**

Activists argue that public markets are not properly valuing a company and that more shareholder value would be achieved if the company went private through buyout of the public shareholders.

Activists commonly make demands for a company to announce the exploration of

strategic alternatives, which is code for seeking a sale, with the announcement itself driving merger arbitrageurs into the stock and leading to short-term stock appreciation. Sometimes activists will act as bidders themselves or partner with private equity firms to make a proposal to acquire the company, hoping to kick-start a process to put the company in play.

Vulnerability assessments on ‘sale of the company’ arguments involve the company staying abreast of the takeover landscape, including any industry consolidation trends as well as the antitrust regulatory climate. At times, the best defence is a strong offence in the form of buy-side M&A. Often with the help of legal and financial advisers, a well-prepared board should understand the potential buyers of the company and the board’s legal obligations in the event of an unsolicited takeover offer.

While deal rumours and the prospect of an M&A premium

typically lead to stock appreciation, a sale of the company is one of the most significant corporate actions for a board. Even a board that believes it is the right time to sell the company is often well-served by controlling the process and timing, maintaining strict confidentiality, and avoiding the perception that the board is under pressure to sell. Any public commitment to explore strategic alternatives in the face of activism should be undertaken with great caution and advice from legal and financial advisers.

### **Governance**

Activists regularly couple their business demands with a criticism about the board and its governance. These governance criticisms usually highlight structural defences that the company maintains that are perceived by some to be shareholder unfriendly (for example, a classified board, an inability by shareholders to call a special meeting or act by written

consent, or a dual class structure), as well as criticisms of specific directors (such as focusing on age, tenure or industry experience).

Activists at times proceed with nominations of their own preferred director candidates or nominate themselves to join the board and push forward their business agenda.

Vulnerability assessments of governance arguments involve the board being updated on the aspects of the company's governance that could be subject to shareholder criticism. Companies are well served to have regular conversations with shareholders about board composition and the company's governance structure, explaining how its governance is designed to support the company's strategy and long-term priorities. Using the proxy statement and company website to highlight the directors and their valuable contributions is often a worthwhile investment.

Many of the same structural defences that make a company vulnerable to shareholder criticism also protect the company from opportunistic activists and hostile acquirers. Giving up structural defences to appease an activist often increases the company's near-term vulnerability, without sufficient credit from other shareholders for taking the action.

Staying united as a board in the face of activist activity is critical to the company's success, and boards should resist being fractured into 'vulnerable' and 'not vulnerable' directors using crude measures such as age and tenure. Vulnerability assessments as they relates to board composition should be handled with great care and respect for the individuals involved.

Being 'vulnerable' and 'valuable' are two side of the same coin in the world of activism. The key to activism preparedness is having a well-advised board, thinking about

the value drivers of the business and viewing the company through the lens of various constituencies, including potential activist shareholders. But avoiding activism is not an end in itself, especially if doing so requires hasty or myopic decisions and importing a short-term orientation into the boardroom. ■

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