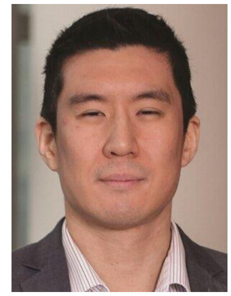
How To Survive Shareholder Activism

By **J.T. Ho and Greg Taxin** (July 16, 2024)



J.T. Ho

Greg Taxin

In an era where shareholder activism is on the rise, companies of all sizes are finding themselves in the crosshairs of activists looking to catalyze change. In the first half of 2024, around 300 public companies faced a public bout of activism in the U.S.[1]

The number of proxy fights in the first half of 2024 has also surpassed the number of fights in each of the first six months of the last four years, with much of the increase in activity taking place at publicly traded closed-end funds.[2] And although large-cap companies received a disproportionate share of media attention, around 75% of activist campaigns during 2023 and year-to-date 2024 took place at small- and micro-cap companies.[3] Any company, large or small, can now face activism.

Similarly, any shareholder, large or small, can become an activist and request — or demand — changes to strategy, governance, operations, compensation or personnel. Long gone are the days when companies could know which of their shareholders would be passive and patient, and which might turn to activist tactics.

In fact, dedicated shareholder activists launch just a small fraction of all activist campaigns. In the first half of 2024, for example, these shareholder activists accounted for just 12% of all campaigns,[4] as a broader group of shareholders are now comfortable being active and engaged.

In this article, we explore the factors that make companies targets for proxy contests and shareholder activism, and we discuss what companies can do in response.

What makes a company vulnerable?

Persistent Underperformance and Low Stock Price

While some activist shareholders are focused on promoting environmental or social causes, most are seeking returns on their investments. For that reason, companies that experience persistent financial or operational underperformance, reflected in stagnant or declining stock prices, may be vulnerable to activism. Underperformance is typically viewed not only on an absolute basis but relative to the company's peers.

Risk Oversight Issues

Sometimes stagnant or declining stock prices may be attributed to nonfinancial factors, such as significant regulatory issues, lawsuits or media scrutiny. In such instances, questions may arise as to whether the board failed to exercise its duty of care, by ignoring material risks or failing to oversee the development of proper controls.

Board Composition and Entrenchment

Long-tenured board members who fail to demonstrate the requisite background, experience, skills, diversity or other desired attributes may be at risk at underperforming companies.

Further, the board chair or the chairs of various committees may be targeted depending on their perceived roles in contributing to the underperformance.

Perceived Lack of Strategy and Infrequent Shareholder Communications

Underperforming companies that do not articulate a compelling turnaround strategy to investors often become targets of activism.

Additionally, these vulnerable companies tend to neglect regular, proactive engagement with shareholders on strategy and governance matters.

Ignoring Shareholders

Companies that ignore shareholder requests for engagement may miss critical feedback about their vulnerabilities, and those that receive but do not act on such feedback risk confronting these issues during activist campaigns.

Compensation Misalignment

While often not a primary factor for shareholder activism, activists will, in addition to focusing on performance and risk oversight issues, criticize executive compensation programs where there is a misalignment between compensation and company performance.

Opportunity for Upside

It is not enough for a company to suffer from performance or governance issues; activists are unlikely to target a company unless there is a possibility for significant upside were changes to be made at the board or management level.

What can vulnerable companies do?

A company can take several actions to address vulnerabilities when targeted by activism, including actions that extend beyond the standard mechanics of a proxy contest.

Effectively Communicating Your Strategy

Companies suffering from poor performance may benefit from communicating to shareholders the reasons for the strategic decisions made to date, and how such decisions may be accretive to the company's long-term value. Companies may benefit from engaging a communications firm and a strategic adviser to help tell their story.

Effective communication may encompass quarterly investor calls, detailed strategic plans in annual reports and transparent performance metrics disclosure. Companies need to craft a compelling narrative that conveys their vision, goals and actions, demonstrating value creation for shareholders. Consistency, clarity and brevity should characterize communications, avoiding jargon and defensiveness.

While social media campaigns are increasingly being used to communicate with shareholders, including during proxy contests, their effectiveness in driving voting behavior remains uncertain. Companies should carefully weigh the costs and benefits of using social media as part of their communication strategy, and consult with their advisers on best practices and compliance requirements.

Thinking Like an Activist

Effective activists present plans to improve company performance or resolve risk oversight issues. Companies should proactively identify potential strategic, governance or personnel changes an activist might push for, and decide whether to implement these changes in advance.

Leveraging Data

Companies can gain insights by using data to compare their performance with industry peers and relevant indices, a common tactic among activists. This analysis not only spots areas for improvement, but also helps articulate the company's value and strategy to shareholders.

Furthermore, data can serve to confirm or refute activist claims, and bolster the company's recommendations. It is also wise for companies to keep an eye on proxy contests within their industry, learning from the successes and mistakes of their peers.

Board Composition and Refreshment

Successful activism campaigns against a company that has regularly refreshed its board to address the company's strategic needs are uncommon, as it is more difficult for shareholders to argue that there is a basis for selecting their nominees.

Companies are advised to regularly assess the composition of their board. Developing a board skills matrix and determining whether the board has the right mix of experiences, backgrounds and tenure can be highly effective in this regard.

In addition, companies should conduct regular board assessments, and use interviews in addition to questionnaires to elicit more candid feedback.

Shareholder Engagement

Companies of all sizes can benefit from regularly engaging with the governance representatives of their largest shareholders following the annual meeting. Proactively engaging with shareholders can help companies to better identify their potential vulnerabilities and make appropriate changes.

Companies can demonstrate their credibility by delivering on their promises, acknowledging challenges and being responsive to feedback.

Identifing and Addressing Material Risks

Companies should conduct regular risk assessments to identify and address material risks. Where appropriate, they might form new steering committees or implement policies to manage these risks.

By publicizing these measures, companies can demonstrate to shareholders that their board and management are actively overseeing risk.

Updating Corporate Governance Practices While Balancing Defensive Measures

Companies can often make governance changes to ease shareholder concerns without stripping away essential defensive measures.

For example, a founder-chaired board that is facing criticism for not being sufficiently independent may address such concerns by strengthening the lead independent role and adding more independent board members. Further, a company that has received low executive compensation "say on pay" votes can address problematic compensation practices without making any board changes.

Before facing an activist campaign, it may also be prudent to strengthen certain protections, provided such changes are reasonable and align with market practice. It is ill-advised to undertake measures that could be viewed as further entrenching the board. Companies should assess their governance practices from both offensive and defensive perspectives.

It is important to note that while it is best to adopt these measures before an activist campaign begins, acting during a campaign can still be pivotal in preventing the loss of board seats or having to make concessions to activists.

Conclusion

By identifying weaknesses, clearly communicating strategies, updating board composition and engaging with shareholders consistently, companies can avoid a disruptive bout of shareholder activism and enhance their strategy, governance, and performance. Taking these steps can turn challenges into opportunities, safeguarding the interests of both the company and its shareholders.

J.T. Ho is a partner and head of the public company advisory practice at Orrick Herrington & Sutcliffe LLP.

Greg Taxin is a managing member at Spotlight Advisors LLC.

[1] Source: FactSet. Data excludes activist filings without publicly disclosed demands and exempt solicitations.

[2] Ibid.

[3] Ibid. Note: Small- and micro-caps are defined as companies under $2 billion in market value at the start of the campaign.

[4] Source: Diligent. Data reflects U.S. campaigns only.