Shareholder Activism Trends in 2019

In many ways, shareholder activists are in the spotlight as never before. How will the market evolve over the coming year?

Shareholder activists are making their presence felt in new ways. The likes of Trian Partners, ValueAct Capital, and Third Point are seeking changes at increasingly large companies, even as smaller active funds and massive fund managers are also becoming more vocal in their shareholder communications. Overall in 2018, there were 199 new activist campaigns launched in North America, up from 194 new campaigns started in 2017, according to Activistmonitor data.

The balance of power between shareholders and companies is constantly evolving, and both sides can claim major victories in recent times. Activists scored a win at eBay, for instance, which in early March agreed to conduct a strategic review of its assets and add three new board seats at the demand of Elliott Management and Starboard Value. In another high-profile battle, Elliott Management's year-long campaign for change at Korean automotive company Hyundai has stalled amid resistance from other shareholders.

The most common types of demands are changing as well, partly in response to the hot M&A market. There were 81 demands for strategic alternatives in 2018 North America campaigns, compared to 64 such demands in 2017, Activistmonitor data show.

As more types of funds make their voices heard in corporate boardrooms, companies of all sizes are being forced to prepare for the possibility of an activist approach. New factors, such as calls for a greater emphasis on environmental, social and governance (ESG) issues, are changing the game as well. How will these and other trends shape shareholder activism in 2019? We spoke with four experts to find out.

Great Adaptations

The experts

Aneliya Crawford
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Mergermarket **Some new types of funds have started taking activist stances, such as mutual funds. Do you think more such funds will begin using activist tactics? What is driving this trend?**

Aneliya Crawford, Schulte Roth & Zabel I think the underlying movement in this direction is based on the fact that there is an enormous flood of money into passive portfolios. That creates tremendous pressure on actively managed funds, including a very broad range of mutual funds and other types of investors, to generate high returns and to show potential investors how their investment philosophy is different and how they're able to deliver those high returns.

What we hear from a lot of our investment fund clients is that they're under pressure from their limited partners and investors to become more active in their engagement with companies. They're also being pushed to apply pressure on companies to pursue certain strategies or rectify obvious problems or take advantage, for example, of a very hot M&A market – whatever the case may be. The passive funds have also become more vocal. The ownership that these fund managers have in public corporations in America and the world has increased dramatically – they decide the destiny of a huge number of corporate votes. I think this circumstance has driven observers to argue that they have to take a more proactive approach at policing poor corporate governance, for example, or complacency on the board, or whatever other issues there may be. It seems logical that if you're such an important player, you have to take your role seriously and do something to improve those companies.

Now, the other part of your question is whether mutual fund companies will engage in the type of activities that a traditional activist would, and I would not expect that to happen. The first and most self-evident reason for this is that it takes a lot of resources to be able to organize a campaign. It's hard to imagine that some of these mutual funds, who are already very leanly staffed, would have the resources to do the in-depth analysis that is required to run a campaign. Some of them are invested in basically every corporation out there, so it's nearly impossible for them to focus their investment thesis on any one particular company and spend the money to implement change in that company.

Professor Minor Myers, Brooklyn Law School

The drivers of activism as an investment strategy are simple: It's high-profile work, and the returns can be very attractive. So it's not surprising to see existing funds dipping their toe in activist strategies or to hear of managers trying to raise new activist-focused funds.

For any particular manager, the question will be whether that manager is successful with the strategy and whether that success is sustainable. Like anything, there will be some flameouts. Activism is harder than it may look to a lot of people and requires that managers do many different things well. First, research and analysis: find a firm in need of an activist intervention, a task of increasing difficulty thanks to new managers. Then, armed with an investment idea, the manager has got to have the operational know-how, the resources, and the grit to get the job done. Every activist manager has to be prepared for the long game: the hard work of confronting potentially hostile incumbents, running a proxy contest, securing some measure of control, and implementing the activist's agenda.

"Activism is harder than it may look to a lot of people and requires that managers do many different things well."

Professor Minor Myers, Brooklyn Law School

In this sense, activist investing is like distilling whiskey. It's expensive, it's hard to do it well, and it can take a long time until you know if it's been successful. But for those who are able to do it well, the rewards can be huge. Many funds may say they're activists, and allocators may be looking to increase their exposure to the strategy, but it's a hard strategy to sustain. Time will tell how many of today's activists can thrive in the long-term.

Professor Claire Hill, University of Minnesota Law School

The big mutual funds aren't able to readily "vote with their feet." They are stuck being invested in companies, so they may as well try to improve them. That appears to be driving them to be less passive than they had been. As they are enlisted by traditional activist investors, they get more involved in appraising and potentially weighing in on what the corporations they have positions in should be doing. Going further than that is a more complex matter, and the extent to which more traditionally passive investors get into the activism business is very much open to question. Certainly, having huge portfolios of many different companies limits the resources you can devote to individual investments unless you are prepared to ramp up significantly.

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How are the tactics used by companies to defend against activists evolving? Are there new techniques that are proving to be effective?

Jack "Rusty" O'Kelley III, Russell Reynolds

There are three things we're hearing more about on the defense side. One is that companies are engaging more frequently with their regular set of advisors on all sorts of scenarios. They're more focused on what could happen and who could enter the picture, realizing that no one is safe anymore from activist investors. Your size and scale don't matter, and you can even be a good performer. So I think there's just a greater awareness that no one is safe from an activist campaign.

The second action we're seeing companies take is proactive director vulnerability analysis. So a company will come to us and say, "If you were an activist, how would you attack our board? Who is strongest and who is weakest?" The boards don't like to do that, but they realize they need to be smart and have the answers to these questions before a proxy campaign begins.

The third thing we see is that I'm being retained to look at the activist's proposed board members, to provide our opinions on the strengths and weaknesses of that slate and to help articulate the argument about why their slate is weaker and ours is better. Traditionally, PR firms would do that, but they're not experts in talent and board composition. As a search firm whose job it is to put people on boards and evaluate people for boards, we have the ability to take a deeper and more nuanced view. So we can look at an activist slate and identify their strengths, their weaknesses, and articulate how to make the argument against them – or, on the other side of the coin, communicate how to make the argument that your client's board slate is stronger.

Professor Minor Myers, Brooklyn Law School

The activist world seems to be evolving in ways that echo the takeover market of a generation ago. Boards, now as then, are nothing if not well-advised. There are battalions of corporate lawyers who help incumbents avoid the disciplining pressure of an activist campaign. And the tools of the M&A market are, not surprisingly, being adapted to defend against activists. So companies have created triggers in poison pill provisions that specifically target activists, as Sotheby's did a few years ago. Bond indentures can include put provisions that are triggered upon a proxy contest.

In other words, a credit agreement can deliver a put right to the bondholder not just in the more conventional context where the ownership of the company changes but also now when the composition of the board changes – precisely the thing that activists seek to change. The effect of these developments is to make activism less financially attractive. Things like the activist poison pill limit the activist's upside potential, while the put provisions will drain away the financial benefits of any activist-induced change.

Beyond these efforts, it will be important to see how the rules of the game develop. This means how, for example, the SEC handles issues like the 13D reporting rules. And how states like Delaware apply the basic fiduciary rules that govern director behavior. The combined effect of these forces will determine what tactics are fair game and what may cross the line.

Aneliya Crawford, Schulte Roth & Zabel

The tactics used by companies are constantly evolving, and they are somewhat customizable in the sense that the type of defense tactic that would make sense depends on the individual situation. One thing that tends to change the momentum and thought process behind a campaign is when a company decides to proactively make changes on its board of directors, because typically, a change on the board is what the activists are looking for. What we often see companies do is they make the change themselves and then argue that because they have refreshed their composition on their own, any change requested by the shareholder is moot.

From the perspective of activists, that's almost never really the case. This has been deployed many, many times by various companies, and I'm yet to see a situation where the board proactively

made board changes and the activist thought to themselves, "Well, that's great. That's what we wanted. The people they now have on the board will solve all our problems."

Usually, what happens is that the activist thinks the whole idea of changing the composition of the board was to have someone who is not picked by the board to be able to ask hard questions and fight for the interest of shareholders. They usually don't want the same cast of characters whom they think have done wrong by the company to pick friends and connections to step in and help them out in this situation. They wanted someone picked by them and by shareholders, not picked by those very same, compromised directors.

But this defensive strategy is often effective. It's harder to convince proxy advisory firms and other shareholders, because they are both inclined to give the new set of directors a chance. So it very much changes the rhetoric and strategy of the campaign.

Professor Claire Hill, University of Minnesota Law School

The main thing I would stress here is preparation, by means of anticipating vulnerabilities and possible activist strategies and also by means of a broader and more continuous focus on shareholder engagement, so that shareholders know more about what the company is doing and why. As the activist business matures, more companies can anticipate being targeted. And for many reasons, including the say on pay votes required since Dodd-Frank, increasing and continuous shareholder engagement has made a lot of sense. The final thing I would note is that activism and engagement are to some extent on a continuum. An aggressive activist campaign seeking to make significant changes to the board is on one end, but listening to shareholders who present ideas that the company decides are good ones and then adopts is closer to the other end.

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How effective do you think the current shareholder proposal system is at balancing the interests of activists and companies? And more broadly, what do you think of the current balance of power between activists and companies?

Aneliya Crawford, Schulte Roth & Zabel

First of all, traditional activists would probably never use the shareholder proposal system in any real way. It's really something that's used by the type of players who have a more patient and general strategy of improving the governance across a broad range of companies, such as the New York City Comptroller.

A traditional activist would probably never consider this an effective strategy, in part because most of these proposals are precatory in nature – they are not necessarily binding on the company, unless they fall within a very narrow category of actions that are within the

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shareholders' powers to decide, as opposed to the board. It's also a fairly prolonged process, involving a lot of back-and-forth with the company about what can or cannot be excluded from the company's proxy. Then, even if you have your proposal included in the company's proxy statement, that means you lose some control over your ability to develop your case and solicit votes in your favor, because you now have a word limit, and it's fairly short, and it is not your proxy solicitor receiving incoming proxies.

If you think of the more sophisticated campaigns that the Trians and Elliotts and Janas and Starboards of the world conduct, their materials include a ton of information, pages upon pages making their case, including tables, valuation analyses, and other details. They're able to solicit proxies in favor of those proposals, so they know where they stand.

To your second question, I don't think the playing field is skewed in favor of activists. I think it's actually the opposite. But it's not particularly difficult for a company to obtain an exclusion of some proposal. In fact, there was recent SEC guidance that seemed to indicate that the SEC will even look to the company as a first source of opinion on a critical issue related to whether a proposal can be excluded. There are certain proposals that can be excluded if they constitute "ordinary business" as opposed to being an extraordinary transaction about which shareholders can opine. If it's "ordinary business," then the company can exclude it because, presumably, this is the type of thing that their board of directors should decide. The SEC had indicated that they would go to the company to find out if the company thought that something was ordinary business.

Professor Minor Myers, Brooklyn Law School

The shareholder proposal system does a decent job for the limited purpose it was designed to accomplish, but it's not a system that can ever do much for anyone who wants to change the direction of a company.

When it comes to public companies, it's the composition of the board that matters. Personnel is policy, and that's where activists focus their efforts. An incumbent board, of course, might be willing to heed an activist's recommendations without a proxy fight. But the threat of the proxy fight affects that choice by the board. If a board has nothing to fear from a proxy contest, then it can stiff-arm an activist with very few consequences.

The one system that really matters for an activist is the federal system of 13D blockholder disclosure. When an activist's ownership stake crosses 5%, they have to make a public filing announcing their holdings. They have ten days to make the filing, and in that window an activist can rapidly increase its exposure to the investment. But even if the activist can acquire 20% of the company, that still means that the activist has to see a really valuable intervention to justify the investment. For every US$1 increase in value the activist creates, it only captures US$0.20. If through regulatory machinations the reporting threshold or window were to narrow, that would make life much harder for activists. And likewise it would insulate incumbents from their pressure.

Professor Claire Hill, University of Minnesota Law School

Before I address the question directly, let me give you some context that informs my perspective. One thing I tell my students is that how a person appraises particular laws depends enormously on the person's view of the people who the laws will affect. For instance, many of my students have a reflexive bias in favor of shareholders and against managers. Until the bias is pointed out to them, they tend to favor the fewest hurdles possible for shareholders to have a voice, through proposals or even lawsuits, in what their companies do. But both sides have pathologies; both sides also have legitimate interests. The challenge is, of course, to get the balance right. Clearly, there are significant costs to companies in having to address shareholder proposals. But some things that have come out of the proposal process have been worthwhile and important. My comments here are of course about the social and governance activists; economic activists are operating in a different sphere.

Ultimately, I think the system is relatively balanced in both directions, and I'm not sure precisely what could be done to make it better. I certainly wouldn't make it easier for shareholders to bring proposals, but I also wouldn't make it easier for their proposals to be excluded. As the present rules do, continuing to take both size of stake and substance of the proposal into account should be continued, perhaps with some tweaking on both fronts.

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M&A, ESG and 13D

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More activist campaigns are being waged with explicit calls for a sale of the company. What do you think is driving this trend? Are activists simply trying to take advantage of the hot M&A market?

Professor Minor Myers, Brooklyn Law School

It's a natural development, but one worth following carefully because of the inherent risks for the target. And it suggests a further blurring of the line between activism and private equity.

One reason it's a natural development is that activist pressure to sell a company may encounter less resistance from incumbents thanks to change-in-control provisions in employment agreements. Implementing a set of operational changes from an activist may sound like nothing but a headache for managers. Pressure to sell the company – and trigger their golden parachute payments – may receive a much warmer reception.

More deeply, I suspect that as time goes on, we'll see increasing specialization among activists. It may be that activism at high-tech firms calls for a very different skill set than does activism in natural resource extraction. Likewise, some activists may begin to specialize in governance changes, while others focus on operational or capital structure changes. And similarly, it may be that a segment of activist managers come to specialize in identifying firms that would generate value by selling the company in a particular way (or, relatedly, by challenging an existing sale already negotiated by the company).

The worry is that there could be latent conflicts of interest that could work to the disadvantage of public equity holders. For example, an activist may threaten an incumbent board with a years-long conflict, possibly leading to professional grief and perhaps personal embarrassment. Maybe that night before bed, the incumbents read the New Yorker's account of Jonathan Bush's experience. All that could be avoided, the activist may say, with a quick sale to us – so quick that no rival has a chance to mount a serious competing bid. The point of corporate law is to guard against these types of conflicts and deter transactions that exploit them, but no system can do it perfectly.

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More traditional activist investors are increasingly incorporating ESG messaging into their campaigns and funds. Do you think this could be effective – either as an investment strategy, a means of attracting investors, or as a means of attracting media attention?

Jack "Rusty" O'Kelley III, Russell Reynolds

I think ESG is critical. Particularly when you look outside of the US, it is how a lot of investing is done these days. I think it probably is clever marketing, but it's also a real issue – so if it is not sincere, it should be, because there will be more and more capital that people will want to dedicate to it. From what we hear and from talking to asset managers who take the money, it is very much here to stay – it is not a passing fad.

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Companies are concerned about reputation, and many activists are as well. And ESG initiatives are something companies will be asked about and pushed to do; it's come to be considered necessary to have a good answer to the question, "What are you doing about ESG?" Do the companies and those asking 'really care' about ESG? There is no monolithic answer: some people involved care, and others may not but think pursuing ESG is necessary for reputational reasons. Does whether they care matter? Maybe not so much. What matters is what companies do.

How ESG plays out as an investment matter is, not surprisingly, hard to measure. There are many different ways it could matter: for instance, might a company particularly known for ESG be better able to weather bad news? Could it have other effects on the bottom line and if so, how and what? There is reason to be agnostic. In some quarters, there has been a hope—maybe even an expectation—that markets would "reward virtue and punish sin"—maybe enough investors would be reluctant to buy sin stocks, or start pricing in significant discounts for legal and other risks. But the better evidence is that sin stocks are not generally subject to a vice penalty. It's easy to think of ways ESG might pay off, including changes in various laws, reputational benefits, as well as business results; it's, again, very hard to measure the incremental effect of ESG on a company's earnings.

The ESG situation is very dynamic. ESG messaging and activity is definitely increasing; precisely what the real-world effects will be remains an open question.

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The percentage of activist campaigns being launched without 13D filings has been rising. What do you think is driving this trend, and how exactly is it affecting campaigns, if at all?

Aneliya Crawford, Schulte Roth & Zabel

I think it may be a combination of two things. The one that seems a little more obvious is the fact that some targets in recent times have been larger, and accumulating a 5% stake that would force you to make a 13D filing in such a large company is really a gigantic investment. It's not something that can easily be done. It used to be the case that the companies that were targeted were more in the small- and mid-cap space because those were the places where you would see serious misalignments in the value of the company, either because it was underperforming, didn't necessarily have the highest-caliber leadership or it was not closely followed by analysts causing the market to not have a true sense of its value. The really large companies were deemed safe. But now, we have seen many very large campaigns. I represented Trian Fund Management in the Proctor & Gamble campaign, which is the largest in history.

So I think that shows that many activists have greater resources and capabilities now. They have access to very high-caliber nominees. They are not concerned about accumulating positions in companies that are staple, household names. If they see an opportunity to close a valuation gap, they will not hesitate to go after the company. When the company is of this size, you really are under the 13D radar, by definition, just because of the size of the position.

The second thing that may not be so appreciated by observers is that the thinking has shifted in terms of what qualifies a shareholder to be represented on the board. It used to be the case that when we were negotiating a settlement agreement on behalf of a client, for example, there were all these discussions: “Should there be one director added to the board? Should there be two or maybe three?” The defense counsel on the other side would almost always say, "Well, your client only owns 3% or 4% of the company's stock. Why should they get three seats on the board, which would effectively be 30% of the board? If you own 4%, you should get 4% of the board."

That is no longer in fashion, and I’m very glad that is the case. I think people have realized that the number of directors who should be designated has nothing to do with your level of ownership in the company. If you have good, qualified people who can help on the board, these are not people who are there to serve the agenda of the activist. These are independent, in many instances highly qualified experts in the specific issues that the board needs to tackle. They are there to serve in their fiduciary duty all shareholders, and therefore how much stock the activist owns has absolutely nothing to do with how many directors they should be able to change on the board, pursuant to an agreement with the company.

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Aneliya Crawford, Schulte Roth & Zabel

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