Activism and Engagement: Yadda, Yadda, Yadda or a Useful tool (or a Little of Both)

by Kenneth Koch, Mintz Levin

Activism is on the rise and everyone's activism defense playbook includes engagement, engagement and more engagement as the principal response.

The experts in the field are well versed in when to engage, who to engage and how to engage. These are all important aspects of engagement, but there is less analysis of when engagement can be expected to work.

The distinction I usually make (and the key to what type of response is appropriate) is whether the activist is a governance activist or a financial activist.

The concerns of a governance activist include matters such as the compensation process, the independence of the members of the board of directors and committees, anti-takeover provisions, appropriate concern for environmental and other public policy matters, related party transactions and a myriad of other matters relating to the functioning and entrenchment of management .

By and large, it makes perfect sense for engagement to be the primary response to governance activists. The arguments pro and con for the matters typically raised are generally well known, but the engagement process, if nothing else, helps sensitize the board of directors to the concerns of its shareholders and permits activist shareholders to feel their voice is being heard, whether or not action is taken.

Often action can be taken or the concerns of the activist allayed by a thoughtful response that is specific to the circumstances of the company. For example, the general framework on the issue of rotation of board committee chairmen or members or term limits on directorships is well fleshed out. Essentially, the arguments for such rotations or term limits are that they encourage fresh looks and avoid the bias that may result from having decided a recurring issue a particular way in the past and having a vested interest (if only subconsciously perhaps) in validating that decision. The argument against rotation is generally to the effect that mandatory rotation and term limits may cost a company hard won institutional and issue related experience and "if it ain't broke, don't put in an artificial requirement to fix it."

In cases like these and many others in the governance area, there are sensible pros and cons and engagement can produce compromises satisfactory to both parties.

Financial activists are more typically concerned with stock buyback programs, increased dividends, asset sales and other measures designed to impact, in the near term, their cash return. A request for board representation often comes along with the demands made by a financial activist. In this circumstance, engagement, while still useful, is much less likely to bring about an amicable solution. There is, in many cases, a fundamental divide between an activist who sees cash on the balance sheet and an immediate, tangible and assured return versus a management team that believes in its business plan and believes that if it makes the required investment and follows that plan, the shareholders will all share in the capital appreciation that will flow from the plan.

In this scenario, a host of issues will conspire against engagement. In the perfect engagement scenario, management would be able to convince the acitivist of the merits of the plan. However, management may, for a variety of reasons be uncomfortable sharing the details of its plan with activists. Regulation FD of the federal securities laws would generally prohibit management from providing material, non-public information ("MNPI") to the activist unless the activist agrees to keep the MNPI confidential and not to trade on the basis of such MNPI. The activist, on the other hand, will not want to enter into such an agreement and therefore tie its hands when it comes to trading its position. Making public disclosure of the plans would solve that problem, but may cause serious competitive and commercial damage. While companies typically do make public their overall strategies, disclosing the details of their plans may rob them of a competitive first mover advantage or adversely impact prices or transactions. As an example, many companies may say that they plan to grow by acquisition, but it would be quite rare to indicate the names of potential targets until an agreement is reached and making such information public may make the transaction less likely to occur and more expensive if it does. So engagement in this case will be considerably more limited than it would be when discussing the executive compensation process or a by-law provision where MNPI is not likely to be involved. In addition, the aims of the governance activist and the financial activist are quite different. Many governance activists view their role as keeping management on its toes and working for the shareholders. They are often content with a well thought out response to their questions and the knowledge that management has given due consideration to their concerns.

Despite the fact that it likely will not be effective, engaging a financial activist is almost always a required step. Failure to do so would lead to an accusation that management takes shareholder interests so lightly that it refuses to even engage in a meaningful discussion. However, engagement with a financial activist is not typically as fruitful as an engagement with a governance activist. Compromise is certainly less likely to succeed as the demands of a financial activist often impact the fundamentals of the operation of the business. The financial activist has typically acquired a stake based on the perceived ability to use the investment as a platform from which to agitate for a distribution of cash in the form of increased dividends, stock buybacks, liquidation, payments from the sale of assets or otherwise. Their interests are often dictated by the need to show their investors short-term returns.

Accordingly, they are not as susceptible to engagement and compromise as governance activists and engagement with them will not necessarily convince them that short-term cash distributions are not the best outcome.

So what does work in such instances? First, let us put to one side those instances where the financial activist is attempting to acquire control and has the funds to acquire a large enough stake to do so. Hostile takeovers and the response to them is beyond the scope of this article, as are proxy fights (though mishandling activism can lead to successful proxy fights). The thrust of this article is to outline the path to dealing with an activist that acquires a platform stake and then uses the platform to try to generate buy in from other shareholders to attempt to turn up the heat on management. In that case, the battle is for the hearts and minds of those other shareholders. In that case, the recipe for success is:

1. Companies should look at themselves (or have others look on their behalf) for vulnerability to financial activists. In addition to assessing what a financial activist might seek (sale of assets, increased dividends, stock buybacks), companies should consider which other shareholders an activist might seek to enlist as allies. Before an activist even reaches out to those holders, the company should have in place an outreach program targeting key shareholders to say why it believes its assets and investment strategy will result in superior gains compared to a return of cash or why an asset that might otherwise come under pressure to be sold fits the strategic plan.

2. Public disclosure should be designed to lift the restrictions of Regulation FD on management to the extent feasible so that management can tell its side of the story to the investment community. There will always be tension between making a disclosure that frees management to concretely discuss its strategy with investors and making premature disclosure and taking on legal exposure for making forward looking statements. This step requires disclosure carefully crafted to balance these concerns and freeing management to give its side of the story in the battle for the hearts and minds of its shareholders. This step is best taken before any activist attack has occurred.

3. Companies should have in place plans and protocols for the outreach program and for responding to activism. It is important that the company speak with one voice (even if there are multiple speakers) and that the messages to be communicated in the outreach program and in response to activism be coordinated. Planning and protocols can go a long way to ensuring that the company takes a coordinated approach.

4. As a preparedness exercise, many companies are engaging investment bankers and others to analyze their vulnerability to activist attacks and to run mock responses to such attacks. Having a mock activist fire drill can help significantly if the real thing occurs.

5. Companies will usually have a team including lawyers and investor relations specialists on call to deal with an activist attack. It is wise to talk to them periodically to learn about trends and to try to develop approaches to an appropriate response. For example, companies should explore whether it is in management's interest to respond to each salvo by the activist. There are advantages and disadvantages to responding. No one wants to be drawn into a public tit for tat, particularly given the “hit below the belt” style employed by some activists. On the other hand, leaving allegations unresponded to may lend them credence. The balance must be struck and the time to discuss the pros and cons of each approach is before any attack occurs.

6. The board and management should engage with the activist (I know I said that it is likely to be ineffective, but I also said it is a required step to show other shareholders a willingness to engage).

7. More importantly, the board should identify and engage with the shareholders the activist is likely to target to join with it. The outreach program mentioned above will hopefully make this part of the response an update call with investors with whom management has already developed a relationship.

8. The board and management's strategy should be clearly articulated. If the issue is investing cash versus distributing cash to shareholders or keeping particular assets rather than selling them, the hoped for benefit of that strategy should be articulated. Again, care must be taken to ensure that these communications do not violate Reg FD and that enough of the company’s strategy has been publicly disclosed to allow management to defend it. Shareholders may listen to a "trust me" approach for a short perio d of time. But long-term success depends upon communicating goals and delivering results.

Taking the above steps can help a company prepare for, and respond to, an attack by a financial activist.

Kenneth Koch is a New York-based Member at the law firm Mintz Levin, which has offices throughout the country. He focuses on general corporate representation and transactions, including public and private equity and debt security financings, mergers and acquisitions, joint ventures and strategic alliances, and venture capital financings. His experience includes representation of both issuers and investment banking firms in numerous public and private securities offerings, as well as buyers, sellers, and financial advisors in a variety of public and private business combinations. http://www.mintz.com/professionals/detail/name/kenneth-r-koch