

CHEAT SHEET

- *Understand the activist claims.* Thoughtfully process and understand the concerns, requests and demands of an activist.
- *Communicate with shareholders.* Trust is not built overnight; it evolves through quarterly earnings calls, annual meetings, roadshow presentations and one-on-one meetings.
- *Communicate with broader constituencies.* The statements raised by activists significantly impact employees.
- *Seek assistance.* New business firms are cropping up to address board and investor dialogue.



THE ODD COUPLE: LIFE WITH AN ACTIVIST SHAREHOLDER

By Michael J. Zylstra and Howard H. Lamar III In a corporate world of increasing shareholder activism, the implications to corporate entities are significant. As the current time has been referred to as “the heyday of hedge fund activism,”¹ the number of publicly traded entities under scrutiny by activist shareholders is at an all-time high. With activist attention and investment in a publicly traded company generally comes: focus by a target’s shareholders on the observations and potential accusations raised by an activist; publicity, often unwanted, regarding the business and certain high-profile employees and/or directors; disruption to the management team in its pursuit of running and overseeing complex and challenging business operations; concern among employees (at all levels within the business enterprise), which can cause challenges with recruitment and retention; significant time and analysis required by the members of the board of directors as to the claims, actions and observations by such activists, and the potential disruption caused thereby; and potential concern among third parties engaged with a business enterprise, including customers, vendors and others. In a competitive business marketplace, the implications of hostile shareholder activism can be very challenging to those empowered to oversee the total corporate environment. As a result, today’s publicly traded companies need to be well prepared to manage a full complement of activities in the face of an activist’s (or multiple activists’) presence and interaction.

Often, activists focus on one or more of three principal areas: operating issues (i.e., how the company is being managed and strategic decision-making); balance-sheet observations (i.e., capital allocation or financial engineering, which includes the use of leverage and whether a company has unproductive assets that should be addressed); and corporate governance (i.e., concern over management and/or board compensation, perceived entrenchment, perceived lack of appropriate governance practices, and composition of the board and its independent directors).

An activist may initially come to an issuer privately or publicly to articulate concerns, subject to certain requirements of public reporting under the Securities Exchange Act of 1934 (as amended) and related regulations. Obviously, the greater the percentage of ownership in the target company, the potential state law limitations, the provisions established in the certificate of incorporation, bylaws and potentially contractually through a shareholder rights plan (if, and as, applicable), and the nature of the demands, will have a more significant impact on a target company and its board of directors, management team and employees in reaction to the actions or observations of an activist.

Part of the recent increased hedge fund activism is a function of recent economic returns. Returns for activist hedge funds in 2012 and 2013 outpaced many other investment indices, and as a result, more capital is being dedicated to such investment vehicles. In addition, with more investment funds actively engaging, there is a broadening range of activist engagement — from traditional actions primarily with large-cap companies to the more recent inclusion of medium — to small-cap (and even micro-cap) entities.²

Understanding the activist claims

Important to the initial interaction with an activist, a company's

representatives need to thoughtfully process and understand the concerns, requests and demands of an activist. To be well informed and properly advised, a company should have the benefit of quality advisers, including legal counsel, financial advisers, proxy solicitors and media relations, should the demands be played out publicly. All of these resources can be invaluable to a company's management and board. With the benefit of a quality advisory team, a company is in a strong position to hear, understand and evaluate the claims, requests, proposals and/or demands of an activist. It is important for the board and management to properly evaluate the interests of an activist, as it allows the company to objectively assess the appropriateness of any proposals and to assess, independently, the best interests of the target company and all of its shareholders. A board will significantly call upon the management team and third-party advisers in evaluating the claims. However, it is imperative for the board, after making an informed and impartial analysis, to act in the best interest of the company and its shareholders.

Although it is understandable that a company whose management is challenged by an activist shareholder may take umbrage, it is important to cultivate mutual respect on both sides. In almost every case, a company becomes a target because the activist believes the company is undervalued or mismanaged, and hopes that an intervention will force change that will result in a higher trading price or other

return to investors. Naturally, that kind of criticism is difficult for management and the board to hear. But the board and management should attempt to make a dispassionate analysis that sets aside any reflexive defensive response. A company should seek to treat all investors with respect and to listen until the point where one or more investors change the tone of the relationship by bullying or making unreasonable demands or false accusations.

It is appropriate for a board to challenge and evaluate, in a dispassionate way, the continuum of action plans and responses to an activist's claims and demands. This thoughtful and engaged approach by a board will greatly assist the company's management team. Because of a management team's employment relationships, related compensation and other vested interests, it is important to allow the board to fully engage in a company's decision-making process. It builds significant credibility with investors and provides broader points of view in the exercise of ultimate decision-making to act in the best interest of all shareholders. The officers and directors duty of care to the shareholders requires that such fiduciaries act in good faith, in a deliberate and informed manner, as a reasonable person would, in the best interest of the company and its shareholders. As a result, it is appropriate for a board to be engaged, informed and willing to act to assess the facts and circumstances. This can require significant time and a number of meetings to be properly informed, and requires the ability to



Michael J. Zylstra is the vice president, general counsel and secretary of Cracker Barrel Old Country Store, Inc. He has more than 22 years of experience in the restaurant and retail industry. mzylstra@crackerbarrel.com



Howard H. Lamar III is a senior member of the Corporate & Securities Practice Group of Bass, Berry & Sims PLC, a full service law firm with offices in Tennessee and Washington, DC. hlarar@bassberry.com

objectively, and in a non-self-interested manner, assess the short-term and long-term best interests of the company. Early on, it is important to educate the management team and board of such demands and the anticipated logistics and commitments required by a company's fiduciaries to evaluate and respond, as required.

Often, investors, including activists, can be focused on short-term "quick fixes" that may provide short-term share price increases without long-term sustainable value enhancement. The trading markets create pressure for quarter-over-quarter improvements, sometimes to the detriment of long-term sound strategies. It is difficult in certain situations to maintain the necessary patience, while also being prepared to thoughtfully communicate the differing results and time periods for the benefit of all constituents. As a result, it is important to have a

consistent and robust communications strategy to convey the company's long-term and short-term plans.

The range of an activist's issues may be broad and often are quite specific to the business of the target company. It is important for a company's board and management, with the assistance of its advisers, to impartially evaluate and assess if any observations or proposals of the activist merit action by the target company. If so, it is best for the target to address them in a timely manner. This reflects a willingness to take action, as appropriate, if it is in the best interest of the company and its shareholders. Inevitably, an activist will seek to "take credit" for such actions; however, it is better to make proper decisions and take specific actions for the good of the company than to fail to take action, as appropriate.

It is often not the first inclination of a target company to seek a settlement

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Employees often are significantly impacted by the statements raised by activists, and a company's ability to positively and confidently address the information needs of its employees can be critical to successfully managing through an activist campaign.

with an activist. Each situation has to be evaluated on its own merits as to the proper response. However, if an activist's concerns and requests have been thoughtfully vetted and determined to have some level of merit, then seeking a settlement may be in the best interest of all shareholders. This may include participation at the board level, as activists often seek one or more board positions. Be careful, however, if the activist is overly adversarial. Boardrooms work best when there is a collegial atmosphere where people can speak openly and respect each other's opinions. Disrupting the balance of this dynamic can adversely impact a board and impair its ability to guide a company effectively. It is critical to seek a solution that attempts to support a continuing collegial environment. Inclusion of one (or more, depending on the circumstances) activist nominee, especially if independent of the activist itself, can provide for a settlement that may well support a company's continuing best interest and allows a significant shareholder added insight and understanding in the oversight of a target company. Notwithstanding the foregoing, it is also appropriate for a company to forcefully defend its actions and positions, if it believes them to be in the best interest of the shareholders.

Shareholder and proxy advisory communications

Our experience reflects that critical to an engagement with an activist shareholder is a company's relationship with its institutional shareholders. Currently, small-, mid- and large-cap institutional ownership is approximately 70 percent of total shares outstanding among US publicly traded companies.³ It is not unusual for a limited number of institutions (15 to 25) to control as much as 60 percent or more of the outstanding equity of a publicly traded entity. Regular, clear and consistent communication with a company's institutional shareholder base is critical to establishing and maintaining a proper relationship with a company's controlling constituents.

Trust is not built overnight, and as a result, it is important to engage in regular dialogue with a company's shareholders. This evolves through quarterly earnings calls, annual meetings, roadshow presentations and one-on-one meetings. It is important for publicly traded companies to proactively engage with their shareholders to build relationships that can support bumps in the road that inevitably impact publicly traded companies. Over time, this interaction with investors will support both management's and the board's understanding of the matters most relevant to the company's core owners. This also allows those shareholders to develop a relationship and trust with the fiduciaries of the business.

Such interactions also can be appropriate to include, from time to time, more than simply a company's senior management team (often the CEO and CFO, sometimes with a COO and investor relations director) by including the independent non-executive chairman of the board, chair of the audit, compensation, or nominating and corporate governance committees, or another independent director engaged with a particular and important

area of the company's oversight and/or operation. These interactions provide not only insight to the business of a company but also provide shareholders an appreciation for the importance of independent oversight through the board of directors. Furthermore, this empowers shareholders to be more trusting of management and the board, and potentially to be less susceptible to claims made by an activist as to allegations of improper or entrenching motives of management or a company's directors. Notwithstanding the potentially persuasive observations of an activist, the development of relationships by a company's representatives over time can be a significant advantage when shareholders are faced with choices in a proxy contest. Obviously, a company's participants have to be mindful of their market obligations and be careful to conduct such meetings without violating Regulation FD.

In addition to a company's direct interaction with shareholders, companies should thoughtfully educate the proxy advisory services, to the extent such entities are open to presentations and interaction from issuers. The more well known shareholder service groups are Institutional Shareholder Services (ISS), Glass Lewis and Egan Jones. It is critical for a company's representatives to articulate the company's vision and strategic plan, as well as the specific elements as to the proper course of action for a company in the face of competing interest(s) of an activist. It requires succinct presentations of the short-term and long-term strategy of the company to support the best interests of all shareholders.

Communication with broader constituencies

As reflected in the preceding paragraphs, communication is critical — not only of the short-term and long-term strategy and vision, but also, as appropriate, to articulate a company's position on specific matters brought

into question. This communication is critical to not only the investment community with ownership and voting power, but also to a company's broader management team, employees, customers, vendors, lenders, competitors (to reflect the continuing relevance, vibrancy and drive of the company), regulators and others who interface with the company.

Company executives are the most acutely aware of the many constituencies that are "listening" to a debate with an activist. The importance of shareholder communication is obvious; however, the collective impact to the company's employees, customers and vendors is also critical to a company's continuing ability to perform at a high level and deliver its products and services. Employees often are significantly impacted by the statements raised by activists, and a company's ability to positively and confidently address the

information needs of its employees can be critical to successfully managing through an activist campaign. As a result, communication needs to be thoughtfully developed to address the interests of multiple constituents associated with a target company. A challenge for many is to "be measured" in one's communications. Often, the tone of an activist is to be inflammatory, sensational and "high volume" — all strategies in order to be heard by the company's stakeholders. A natural response to such statements is to strike back with equal "volume." However, a company's ability to be measured, factual, logical, less emotional and on point can be far more effective. Each situation has its own circumstances, and there will be times to be very direct and clear as to the opposing views. However, it is important to do so with a proper tone, which requires significant discipline. This is especially true

when the allegations raised by an activist seem most egregious, personal or when the time frame of the debate has been stretched over a significant period (multiple engagements, multiple proxy contests, etc.).

Activists are likely to be less measured since they are challenging the status quo. Management may be offended by perceived grandstanding but should resist the temptation to respond in kind. Management's broader constituencies, which includes all shareholders, the broader investment community, employees, customers, vendors and others, expect a company to show restraint and to respond thoughtfully. In responding, a company needs to remember that other investors (and other constituencies) could well share some of the activist's concerns. It is important for shareholders and such other parties to hear how management and the board are focused on



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Interestingly, as activism activity has increased in recent years, new business firms are cropping up to address board and investor dialogue. In recent times, as noted by *The Wall Street Journal*,⁴ companies such as iiWisdom and CamberView Partners have been formed, and in addition, Shareholder-Director Exchange and a task force at Conference Board have each published guidelines to support the strengthening of relationships between investors and companies. Not only can these tools be used in the face of an activist engagement, but also in advance of one – especially if a company does not believe it has developed an appropriate communication strategy with investors.

Concluding observations

It is our belief that today's heightened activism is not a passing fad but is here to stay in a significant and meaningful way. The implication of significant capital being allocated for such investment speaks volumes to what publicly traded companies should anticipate moving forward.

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Shareholder Activism and Corporate Governance (Sept. 2013). www.acc.com/article/shareholder_sep13

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This mandates that corporate representatives need to be thoughtful and remain sensitive and vigilant in their role as fiduciaries and leaders of publicly held entities. Management and boards will not be perfect, not all business decisions will be correct, and various risks and impacts in the economic marketplace will affect operating results, all of which may become the focus of debate among one or more activist investors and a corporate entity. However, publicly traded companies can seek to stay ahead of unwanted activism interest by being mindful of certain actions within their realm of control. The following is a summary of matters often focused upon, outside of specific strategic or operating decisions, that merit proper management and board oversight:

- Maintain a clear and concise communication effort with investors and the broader marketplace.
- Be prepared to speak with a consistent voice on behalf of a company — through the chief executive officer and often through the utilization of one or more independent directors who are properly knowledgeable regarding the issues at hand.
- Maintain a culture of vigorous and open discussion to promote new ideas and thoughtful scrutiny of strategic and operating plans and opportunities.
- Be studious of balance sheet analysis and capital allocation.
- Routinely evaluate a company's corporate governance practices and enterprise risk management.
- Maintain appropriate oversight of a company through your independent directors.
- Maintain advisory relationships that can be called upon promptly and that are up to speed on your company.
- Be mindful of the need to evaluate requisite skills, experience and composition of the board, as well

as tenure and service (of both management and independent directors) in the best interest of a company.

- Seek to properly gauge management and director compensation to support your philosophy and performance.
- Be aware of social responsibility issues affecting a company's business.

There are no “silver bullets” or “magic pills” to avoid the potential interest of an activist. And, more important, the existence of an activist is not an indictment that is supportive of poor decision-making or governance practices. However, in a current environment of significant and increasing activism, management and the board of directors of publicly traded companies need to be self-observant and promotional of consistent review and action to continually evaluate the total corporate enterprise. **ACC**

NOTES

- 1 John C. Coffee, “Hedge Fund Activism: New Myths and Old Realities,” *The CLS Blue Sky Blog*, May 19, 2014, clsbluesky.law.columbia.edu/2014/05/19/hedge-fund-activism-new-myths-and-old-realities/.
- 2 Posted by Noam Noked, “Adjusting to Shareholder Activism as the New Normal,” *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, Sept. 4, 2013, based upon a Sullivan & Cromwell LLP publication by Joseph B. Frumkin, H. Rodgin Cohen, Francis J. Aquila, James C. Morphy and Glen T. Schleyer, blogs.law.harvard.edu/corpgov/2013/09/04/adjusting-to-shareholder-activism-as-the-new-normal-2/.
- 3 “How is the 2014 proxy season shaping up thus far?” *Proxy Pulse Second Edition 2014*, A Broadridge + PWC Initiative, www.pwc.com/en_US/us/corporate-governance/publications/assets/proxypulse-2nd-edition-june-2014.pdf.
- 4 Liz Hoffman, *The Wall Street Journal*, “Wisdom Aims to Give ‘Quiet Majority’ of Investors a Voice,” June 17, 2014.