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In Activist Campaigns, Board Members Can Be Valuable or Vulnerable

By Jason Frankl, Robert J. Kueppers, and Kurt Moeller

When an activist investor begins accumulating a public company's shares, the dialogue among company executives, board members, and advisors at some point turns inward to consider which board members might be targeted for replacement in a proxy contest. Even with exceptional due diligence, it can be difficult for an outside investor to determine which directors may be open to change and which may not. Therefore, when shareholder activists decide who they want to replace, they look at several factors, including a director's tenure, industry knowledge and experience, board leadership roles, personal share ownership, and any relationships that might compromise a director's independence, such as family connections or transactions between related parties.

Enter the Pandemic

The COVID-19 crisis clearly disrupted activists' appetite for full-fledged proxy contests, at least for 2020. The rapid decline in many companies' share prices began in late February, leaving activists far too little time to build positions, develop a case for change, and identify and nominate directors before this year's proxy season. The sharp declines in economic activity and consumer spending throughout the world have made near-term revenue and earning power at many companies far less certain, and have highlighted the importance of raising and preserving cash to last until a new normal emerges. The downturn in revenue also forced many companies to reduce staff and, in some cases, the pay of remaining employees. All these factors have made the optics of shareholder activism challenging and rendered unusable one classic activist change tactic: Cut costs and add debt in order to repurchase shares or increase dividends.

We should not expect shareholder activists to lock themselves down permanently. The highest number of US proxy contests since the financial crisis was seen in 2009, according to Institutional Shareholder Services. The economic dislocations caused by COVID-19 should give rise to wider variations in fundamental performance and stock price across industries and among peers.

The receding economic tide will likely result in more targets for activists and more campaigns where the activist and the company have widely differing viewpoints. As such, we should expect that more campaigns will go to a shareholder vote over the next few years than in recent years, when a strong US economy meant fewer companies with fundamentals that appeared weak and in need of substantial improvement.

So, what are the attributes that could result in directors becoming targets in next year's proxy contests?

Tenure. Poor stock performance relative to peers often inspires activists. When activists target directors for removal, they frequently focus on the longest-tenured directors, who may be perceived as the ones most responsible among board members if the company has performed inadequately over an extended period. Even when a company's poor performance is shorter in duration, an activist may claim that a particular director's long service has led him or her to be too aligned with management and resistant to new ideas. The United Kingdom accepts this view, deeming a director with nine or more years of service on a board to be non-independent. US regulators base the independence of directors not on tenure but on their business relationships with the company.

In a 2019 campaign against a real-estate investment trust, an activist shareholder targeted four directors, each of whom had served on the board for at least 20 years. Shareholders apparently were unenthusiastic about reelecting those long-tenured directors, as shown by the company's last-minute settlement with the dissident, which replaced the four directors with the dissident's four nominees.

Industry knowledge. Activists also target directors with limited operational or domain expertise. Directors typically gain such expertise and insight through current or recently completed executive experience within an industry. This lends credibility to a director as both a sounding board and a source of constructive and critical feedback for management. Those without executive experience in an industry can gain requisite knowledge and add substantial value, although it may be difficult to demonstrate such knowledge in a way that shareholders can readily observe.

A 2017 proxy contest saw an activist investor seek representation on the board of a consumer goods company filled with current and former CEOs of large, influential enterprises in a range of industries. The activist was successful in pointing out that no outside director had recent experience in the consumer segment. Another contest that year involved an apparel company with several directors whose appointments appeared to be related to their geographic proximity to company headquarters, as their executive experience had little obvious relevance. In both contests, shareholders reelected all company nominees, but within two years, each had replaced at least two of the directors with questionable experience.

Board accomplishments. The confidentiality of boardroom discussions makes it difficult to publicly identify the contributions each director makes, but for some roles there are tangible metrics. For a director who chairs the audit committee, investors can determine whether the company has materially improved the transparency of its financial disclosures. Investors may also look at changes the company has made to its executive compensation plans when assessing a compensation committee chair, and at board refreshment practices when assessing a nominating and governance committee chair.

In a 2017 proxy contest against a technology firm, the nominating and governance committee chair was targeted, but that director could point to two recent additions to the board that brought diversity and valuable skills as evidence of his positive contributions. That director was reelected.

Two years later, a proxy contest involving an energy company focused on corporate governance. The company nominated a new director who positioned himself as a change agent. The director correctly noted that, in his first year leading a different public company's governance committee, that company had declassified its board, apparently on its own and without shareholder pressure.

His track record proved highly relevant.

Share ownership. A common activist criticism is that the activist owns far more shares than directors and management combined. While an activist typically invests institutional investors' funds, making the comparison somewhat unfair, the point has some validity and resonates with other shareholders. In his February 2020 annual letter to shareholders, Warren Buffett explained that he feels better when directors buy shares with their own capital instead of solely being shareholders as a result of equity that has been granted to them for board service. Even more concerning than when directors have never bought shares is when they have sold the shares that they were awarded, reducing their alignment with shareholders and implying a lack of confidence in the company's future. Such sales increase a director's vulnerability to an activist, regardless of the underlying reason.

In a 2017 proxy contest against a retailer, the activist noted that its ownership stake of approximately 9 million shares was 100 times greater than the stake of the two targeted independent directors, who together owned fewer than 90,000 shares despite each having been on the board for at least 10 years. That comparison likely contributed to the activist winning all the board seats it sought.

Personal relationships. Activists are likely to call attention to any relationships that directors have with executives outside of their roles on the board, even when such relationships are fully disclosed. These relationships could include business ties at previous companies, related-party transactions, family connections between directors and non-management employees, and even social ties between a director and a member of management. In a 2018 proxy contest, an activist investor demonstrated that the company's newly nominated independent director had initially been recommended by the company's CEO and lived in the same subdivision as the CEO. This called into question the nominee's independence and contributed to his not being elected, as two activist nominees won board seats.

The best preparation cannot entirely prevent activist aggression, but it can make a company a less appealing target. Just as the board can proactively seek to enhance financial results and capital allocation, it can maintain its focus on improving corporate governance. Boards can improve such areas as financial disclosures and executive compensation while undertaking regular refreshment that adds directors with highly relevant experience. Individual directors also can take actions, such as retaining for lengthy periods any shares they are granted and ensuring that the company fully discloses improvements to corporate governance, to reduce their vulnerability and allow outsiders to see how they have aligned themselves with and add value to shareholders.

At FTI Consulting, Jason Frankl is a senior managing director and coleader of the firm's activism and M&A solutions practice, Robert J. Kueppers is a senior advisor, and Kurt Moeller is a managing director in the activism and M&A solutions practice.