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## SHAREHOLDER ACTIVISM

## Preparing for the Activist Challenge in the Mid- and Small-Cap Market



BY BONNIE J. ROE

Shareholder activists get more attention in the media when they pursue large-cap companies, but shareholder activism has long been part of the mid- and small-cap market. Smaller companies may actually be easier targets, because it will be less expensive to acquire a significant position in the stock, and there may be more inefficiencies in pricing and liquidity that can be exploited by an activist investor over the course of its investment. Mid-cap and smaller companies are often ill-prepared for the onslaught of an activist campaign. They may not have an articulated corporate strategy; their corporate governance systems may be easier to attack; and they may have trouble engaging with their shareholders. Unwilling to devote resources to a fight, they may give in too readily to activist demands. Or instead, they may reject negotiations, dig in their heels and risk everything in a battle for corporate control.

With advance preparation, the prospects for mid-cap and smaller companies can be significantly improved. Preparation involves analysis of the company's corporate strategy, governance and investor relations, and a

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willingness to engage and make changes before an activist appears on the scene. Most of this process can be led or guided by company counsel, but ultimately the process requires commitments of time and resources from the company's chief executive officer, other management and the board of directors, as well as input from a proxy solicitation firm. The same process can (and should) be used by larger companies, but they may face different challenges along the way.

**Know thyself (corporate strategy).** Activists exploit weaknesses, real or perceived, in the company's business model and execution. They typically propose solutions such as a special dividend, an acquisition or sale, a spin-off or roll-up, a significant change in operational strategy or a change in management. Companies should understand what types of alternatives are likely to be proposed and be able to explain their existing strategy and why it is superior to these alternatives. This analysis may identify changes that could be made in corporate strategy, as well as risks associated with the company's existing strategy or alternatives. Whether or not changes are identified, a thoughtful strategic review process will generally help create a good record for the company and enable it to respond more effectively to an activist's challenge.

**Know thyself (corporate governance).** Activists attack companies for flaws in their governance practices, again whether real or perceived. Mid- and smaller-cap companies are often more vulnerable to activists' critiques, because, out of the spotlight, they have not needed to make some of the governance changes that larger companies have made over the past 10 or 15 years. Preparing for activism requires a systematic review of the company's corporate governance policies; its corporate charter and bylaws; board committee charters; codes of conduct; executive employment agreements; stock incentive plans; and similar documents. Counsel should compare these policies to those of the company's peers and to "best practice" recommendations, including the recommendations of proxy advisory services such as Institutional Shareholder Services and Glass Lewis. The goal here is not to blindly

follow other examples, but to learn through comparison and limit the number of governance issues for which an activist might criticize the company. This may be a good time to address obvious shortcomings, like an aging chief executive officer who has no succession plan, or a board with no strong independent directors. But if an activist challenge is clearly on the horizon it may not be the best time to bring in more than one or two new directors, as it can take time for a new director to learn about the company and for the interpersonal dynamics of the board to develop in a positive direction.

Companies should also assess their governance posture from a defensive point of view. Do the bylaws permit stockholders to call a special meeting and, if so, what percentage of the stock must they hold to exercise such right? What must a shareholder do in order to nominate directors or present a proposal at the annual meeting? Do the bylaws limit the forum in which claims for breach of fiduciary duty and similar claims may be brought? If the bylaws can be amended without shareholder approval, it may make sense to adopt defensive measures to strengthen the position of management and the existing board against a potential activist or unwanted suitor. Similarly, the company might consider either adopting a shareholder rights plan (poison pill) or preparing one to sit “on the shelf” (ready to be adopted if needed).

**Know thy shareholders (analysis, engagement and communication).** Companies should understand the composition of their shareholder base, and the likelihood that various groups will support an activist campaign. What portion of this base is represented by retail shareholders, how much is held by long-term institutional holders and how much, if any, is represented by hedge funds and other potentially short-term investors? Who are the most significant investors, and what positions have they taken in other potentially contested situations?

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The best answer to questions about a company’s shareholder base will almost always begin with information from a proxy solicitation firm, with experience looking behind the Schedule 13D, 13G and 13F filings that publicly disclose the holdings of significant shareholders. Shareholder composition can change, quickly and unexpectedly, at key moments, with little or no notice. For example, retail holders may sell out quickly to hedge funds, who may nonetheless be able to avoid triggering disclosure obligations under Schedule 13D. To keep track of these changes, companies must update their information regularly in order to understand their shareholder base.

Unfortunately, small-cap companies may not be able to benefit from the relative stability of holders such as index funds and larger mutual funds, that either must

hold certain stocks that are included in an index or cannot hold stocks that do not meet certain liquidity requirements. But it would be wrong to assume that institutional holders will always vote against activists; some are more receptive than others, particularly if the stock has not been performing well. Similarly, while retail investors are generally assumed to favor management, this is not always the case, again particularly in the face of poor stock performance.

More important than the statistical analysis of the company’s shareholders is getting to know and developing a relationship with key shareholders and their representatives. Over the past few years, larger-cap companies have pursued shareholder engagement programs with significant success, motivated perhaps by the desire for positive votes in response to “say-on-pay” voting requirements. It is always hard to get the attention of major institutional shareholders, however, and it is particularly hard to get their attention when the company’s stock represents only an infinitesimal portion of their overall portfolio. Mid-cap and smaller companies may still get credit for trying to make the connection, and they may achieve more success in getting their shareholders’ attention by engaging holders outside of proxy season and approaching holders that have a particular interest in their stock. They may also be able to engage with niche investors at industry conferences and similar venues and forge relationships through direct outreach to other investors who hold significant positions in the company but are not traditional institutional investors.

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The tactical objectives of any shareholder engagement or outreach program are, first, to understand the concerns and perspectives of key shareholders and, second, to communicate the company’s strategic vision and position on various corporate governance matters. The overriding goal, however, is to establish a relationship and open up a dialogue that can be useful to the company in the event of a shareholder activist campaign. The principal legal issue is to make sure that no material nonpublic information is conveyed to the shareholders in these discussions, even as sensitive issues are discussed. Also important is to make sure that the company speaks with one voice, that is both authentic and informed. As a consequence of these various concerns, it is usually best to channel all communications through the chief executive officer, in the presence of another person, often the general counsel or chief financial officer. If any hitherto nonpublic information is likely to be shared, the company can disclose it in a Form 8-K filing made before the disclosure. If any

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nonpublic information is inadvertently shared, the company can disclose it, again on Form 8-K, immediately following the inadvertent disclosure. The communications process should not be taken lightly; it should be planned and carefully tailored to the company's strategy.

Companies should also use the regular public reporting process and informal public disclosures, such as press releases and earnings conference calls, to convey their strategy directly to shareholders and members of the general public. Of course, these communications are supposed to convey the company's strategy, but particularly for mid- and smaller-cap companies, the message may get lost in boilerplate that has not been refreshed for several years. In any event, the message usually can be conveyed more frequently, forcefully and directly. Faced with the possibility of shareholder activism, companies can and should make sure they convey their objectives, their strategy and their corporate governance practices, in clear and consistent terms.

**Know thy activists.** Occasionally, company officers will engage with a shareholder casually, without knowing that the shareholder is an activist, or engage knowingly with an activist or potential activist, without understanding the kind of activism they engage in. The more the company learns about its shareholders and the activist investors in its industry and market, and the more carefully it organizes its communications, the less likely these mistakes are to be made.

**To thine own self be true (what to do when the activist comes).** No matter how thoroughly a company prepares, it may eventually face an activist challenge. The best strategy is generally to engage in discussions with the activists, but (if at all possible) not to concede on matters that are not otherwise in the best interests of the company. With a thoughtful corporate strategy, sound corporate governance and good communications with its shareholder base, the company will be able to negotiate with the activist from a stronger position than it would without those advantages.