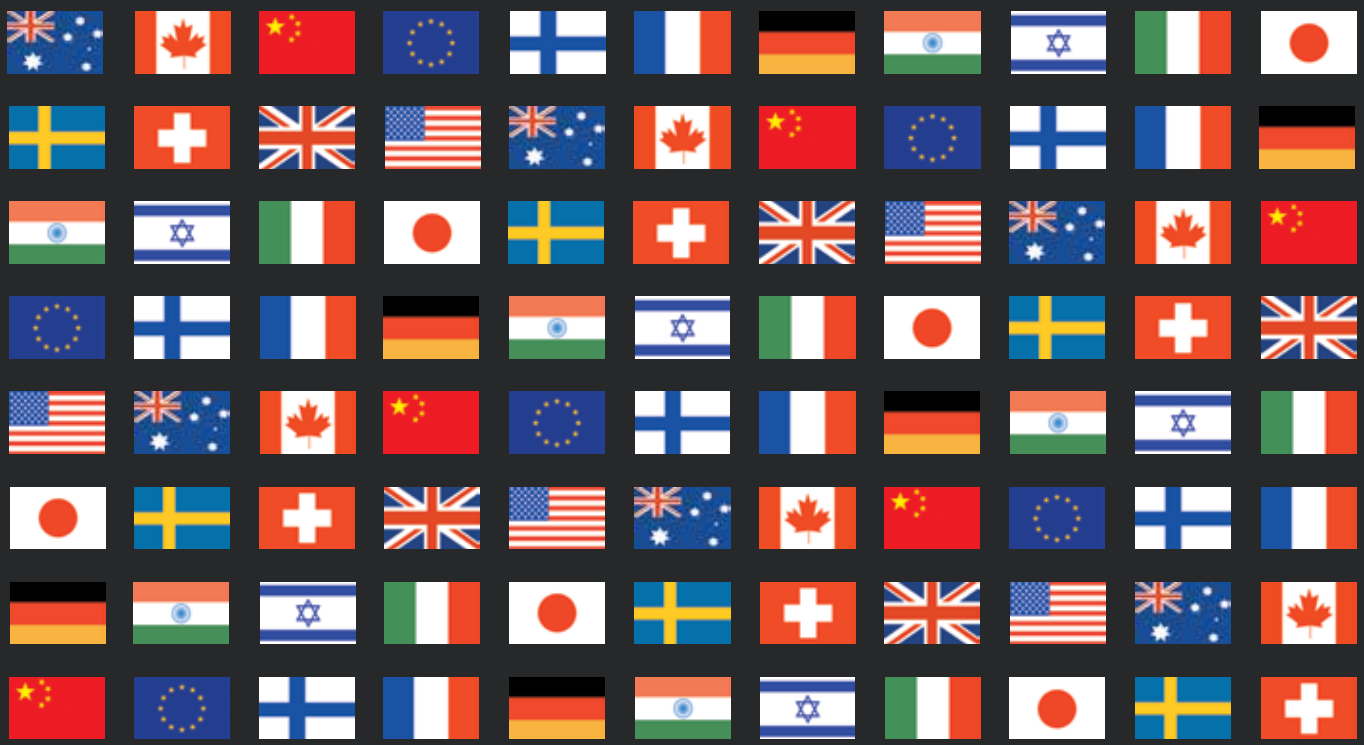
Shareholder Activism & Engagement

Contributing editors
Arthur F Golden, Thomas J Reid and Laura C Turano



2016

GETTING THE DEAL THROUGH

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Shareholder Activism & Engagement 2016

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Law Business Research

THE QUEEN'S AWARDS FOR ENTERPRISE: 2012

Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 3708 4199
Fax: +44 20 7229 6910

First published 2016
ISSN 2397-4656

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

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Introduction

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At the end of another record-breaking year for shareholder activism activity, it is appropriate that we ring in the publication of this, the inaugural edition of *Shareholder Activism & Engagement*, part of the Getting the Deal Through series. We are pleased to serve as editors of this volume because we believe that shareholder activism is and will remain in sharp focus in financial markets, in the C-suite and in the boardroom, and that shareholder engagement is, and will continue to be, a leading and increasingly sophisticated priority. The international approach of the Getting the Deal Through series is especially apt for this topic, which we expect to become increasingly global over time, with 'imports' and 'exports' of shareholder activism and engagement between jurisdictions. Although the United States remains its dominant market, such activism and a heightened sensitivity to shareholder engagement is truly a global phenomenon.

The chapters of this volume, written by esteemed practitioners around the world, outline the legal parameters of the shareholder activism and engagement landscape. This introduction takes a step back from the legal intricacies, discusses trends we are observing on the ground and speculates on the area's future direction.

Evolution of shareholder activism in light of increased 'firepower'

In the past year, we have seen hedge fund shareholder activism reach new heights, both in the number of campaigns (estimated at the time of writing as more than 230 campaigns in the United States alone in 2015) to the size and iconic nature of the companies targeted (eg, AIG, DuPont, General Electric and General Motors). However, that increase is not surprising; since the US's Great Recession nearly every year has been one of unprecedented shareholder activism. In many ways, the years leading up to and following the Great Recession have been an ideal breeding ground for activists. The corporate scandals of the early 2000s and the financial crisis have left many retail investors sceptical of management teams and the status quo. The years following the Great Recession left some companies with extra cash on their balance sheet (setting the stage for activist campaigns on how that cash should be deployed) and left other companies as apparent laggards to their peers in the recovery (setting the stage for activist campaigns on improving operations and on extreme changes, such as divestitures or a sale of the company itself).

Although we do not believe that we have reached the pinnacle of shareholder activism, we do believe that it will be important to watch how shareholder activism evolves in light of the substantial increase in assets under activist management (estimates of aggregate assets under management range from US$120 billion to over US$200 billion). While more assets under management means that activists have increased firepower, it also brings with it a confluence of challenges. We believe that the increase in assets under management will manifest in a number of ways, including in:

- the companies targeted (with respect to size, to relative performance to peers and to geography) as shareholder activists must work harder, often over-reaching to identify possible targets;
- the focus of campaigns, as shareholder activists reach for additional arguments for why change is necessary at a target company (arguments we expect to become more company-specific and operation-specific rather than generic financial engineering or balance sheet activism); and
- greater recognition that not all shareholder activists are created equal or play by the same playbook (something we already know to be the case but believe will become more apparent to outside observers as the cast of shareholder activists and the scope of their activities expand).

Shareholder activist campaigns

We also believe that it will be important to monitor how shareholder activism evolves in light of the increasingly routine nature of the shareholder activist campaign itself. It has been a few years since large-cap, household-name companies such as Apple, Microsoft and Pepsi were first targeted by shareholder activists. Although the targeting of these companies sent the message that no company is immune to shareholder activism, it also may have removed some of the sting of being in the crosshairs of an activist. The path to a settlement with a shareholder activist is now increasingly well trodden, as demonstrated by the decrease in the number of days between the announcement of an activist's stake in a target company and the announcement of a settlement (calculated by some to be within 56 days, a 24 per cent decrease from the average number of days in 2013) and by the increasingly 'standard form' nature of the cooperation agreement executed between a shareholder activist and the target company to memorialise their settlement.

The increasingly routine nature of a shareholder activist campaign may manifest itself in a number of ways. In the long term, there could be more scrutiny of companies capitulating too quickly to an activist's demands. At this time, for example, Institutional Shareholder Services does not require that a shareholder activist seeking a minority position on the board provide 'a detailed plan of action, nor that the [activist] prove their plan is preferable to the incumbent plan.' Instead, the activist only has to demonstrate that 'change is preferable to the status quo and that the [activist's] slate will add value to board deliberations of the issues at hand.' This standard lends itself to Nelson Peltz's 'chicken soup' version of shareholder activism (ie, that a shareholder activist's nominee is like chicken soup: 'How can it hurt?').

Many long-term investors are beginning to question the 'chicken soup' theory. They note that it is rarely the case that the activist's idea is for a company to 'innovate and invest' in long-term growth with the highest net present value, as opposed to seizing immediate opportunities to 'divest and distribute' with a high internal rate of return. In this regard, many have likened activism to 1980s-style leveraged buyout-driven private equity, without having to buy all of the company. As the shareholder activism asset class reaches maturation, activist strategies will have to develop because it cannot be the case that 'divest and distribute' is the right strategy for shareholder value as often as is advocated by activist funds relative to other ideas. An activist fund that occasionally saw opportunities to work with a management team with an innovative, value-creating idea that required a major investor to support the financing of the innovation would be a refreshing development.

Settlement or cooperation agreements

If shareholder activist campaigns continue to be resolved at an increasingly rapid rate, we also question whether the 'chicken soup' philosophy will be tested in the long term, and whether there will be increased scrutiny of boards agreeing to such settlements. In addition, we question whether shareholder activists will continue to be satisfied in the long term with settlements that are easily reached, or if the speed of recent settlements may encourage activists to push settlement terms that are more difficult for a target company to swallow (motivated either by the recognition that those terms are important or a belief that prolonging the activist fight has some other value to the shareholder activist).

Finally, it will be important to monitor how international practice evolves regarding settlements. As the various chapters in this volume

illustrate, the legal landscape in which shareholder activism and engagement operates differs greatly from jurisdiction to jurisdiction. However, it would be unduly provincial to believe that the settlement framework in one jurisdiction will not inform the settlement framework in another jurisdiction, especially with respect to shareholder activists that target companies in multiple jurisdictions.

Political tides may increasingly influence shareholder activist campaigns

Shareholder activism and engagement does not occur in a vacuum. In Japan, increasing shareholder activism is likely tied to the corporate governance reforms promoted by Prime Minister Shinzo Abe, as part of the 'third arrow' of his economic growth policy of Abenomics. We expect politics to continue to impact shareholder activism and engagement this upcoming year. The supposed short-term attitude of shareholder activists has already been fodder for Hillary Clinton, currently a Democratic candidate for US president. We would not be surprised if shareholder activism, which is inextricably linked to, among other things, the securities disclosure regime and the tax regime in which the activist operates, continues to receive attention in the US presidential campaign and becomes a political topic in other countries as well.

14a-8 proposals and proxy access

Shareholder activism is not limited to well-publicised campaigns waged by activists with billions under management. Shareholder activism in the US includes proposals submitted under Securities Exchange Act Rule 14a-8, which requires a company to include a shareholder proposal in its proxy materials if certain requirements are met (eg, the shareholder owns at least US$2,000 or 1 per cent of the securities entitled to vote on the proposal). This past year, 'proxy access' demonstrated the outsized influence that 14a-8 proposals can have on corporate governance policies and trends. 'Proxy access' refers to the right of shareholders (who meet certain requirements) to include their nominees for director on the company's proxy card, allowing the shareholder to avoid the expense of sending out his or her own proxy card. In 2011, the DC Circuit struck down Securities Exchange Act Rule 14a-11, which would have granted proxy access (limited to 25 per cent of the board) to 3 per cent shareholders who held their shares for at least three years. In 2015, proxy access was thrust back on the agenda by 14a-8 proponents. In the 2015 proxy season, more than 100 companies received proxy access proposals, which, on average, received shareholder support of more than 54 per cent.

In addition, a 14a-8 proxy access proposals also demonstrate:

- how companies are increasingly adept at responding to shareholder proposals and navigating the preferences of their shareholder base; and
- how institutional investors (eg, BlackRock, T Rowe Price and Vanguard) are increasingly vocal and have bespoke policies on corporate governance issues. As a result, we fully expect most companies that receive a proxy access proposal in the 2016 proxy season to evaluate it and to respond in light of the voting policies and practices of the company's shareholder base.

We also expect institutional investors to continue to be vocal on corporate governance issues. In the last year we saw, among others, BlackRock, State Street, T Rowe Price and Vanguard sending well-publicised letters (and in some cases, multiple letters) to their investee companies on corporate governance topics. We expect this trend to continue and for other investors and public policy groups to join the fray.

Shareholder engagement

Shareholder engagement continues to be a leading and increasingly sophisticated endeavour for companies. It has now become relatively commonplace for companies to devote substantial internal resources and engage external advisers to manage shareholder engagement efforts. After years of advisers echoing the importance of shareholder engagement in the proxy off-season, so many companies have heeded such advice that proxy advisory firms and institutional investors have had to ask companies not to request meetings unless there are concrete items to discuss. We are hopeful that best practices for shareholder engagement will evolve to recognise that the substance and frequency of shareholder engagement efforts is not a one-size-fits-all endeavour, and that high-quality, thoughtful engagement is more important than quantity.

Final note

This first edition of *Shareholder Activism & Engagement* aims to provide an overview of the global shareholder activism and engagement landscape, the laws and regulations that may promote or harness shareholder activism and engagement, and the campaigns that have both coloured perceptions and influenced the course of shareholder activism and engagement.

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Shareholder Activism & Engagement
ISSN 2397-4656

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