

State Street Warns Companies Against Settlement Agreements with Activists that Focus on Short-Term Goals

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Activist campaigns targeting companies with market capitalizations above \$500 million have resulted in approximately 13% of total new board appointments in 2016 so far. As of August 2016, 49 companies have settled with activists by conceding 104 board seats, which is nearly the same number as during all of 2015. Less than 10% of board seats gained by activists in 2015 and 2016 were through a proxy contest, compared with 34% in 2014.

The increasing number of settlements in activist situations has led to [a report](#) by State Street Global Advisors (SSGA). The investor is concerned that the rapid rise in settlement agreements may represent a focus on short-term priorities at the expense of “near-permanent” index investors. While recognizing that activists can bring positive change to underperforming companies and noting that it has supported some activists in the past, SSGA notes that it is wary of activist models that favor short-term interests at the detriment of long-term growth.

Acknowledging that the strategies pursued by activists differ by activist and by company, SSGA identified certain “red flags” for long-term investors that raise questions about the motivations behind activist actions, including: (a) significantly increasing CEO pay without explanation; (b) changing the performance metrics for CEO pay by incorporating EPS as the primary driver, which could favor activities like share buybacks over allocating capital for the long term; and (c) focusing on “financial engineering” activities such as share buybacks, leveraged dividends, spinoffs and M&A.

SSGA wants boards to evaluate settlement agreements carefully for the following issues:

Duration of agreements. Whether agreements should extend for longer periods than the typical 6 to 18 months, which could lead both companies and activities to be more sensitive to longer-term factors.

Time period for holding shares. Instead of the current practice of preventing activists from increasing their stakes in the company above a certain threshold during the term of the agreement, SSGA believes that activists should be required to hold shares for long periods to align themselves with long-term shareholders.

Minimum ownership thresholds or director resignation requirements for board representation. Agreements should specify minimum ownership levels for longer periods in exchange for board representation, rather than the typical agreements that allow activists to reduce their stake to 1-2% below ownership levels that existed at the time of settlements. In addition, companies should require directors who are affiliated or not fully independent of the activists to tender their resignation if the ownership level of the activist falls below a minimum threshold. Boards can themselves nominate those directors as their candidates if they choose.

Risks due to pledging. SSGA has found that activists who own a considerable stake in target companies often pledge a significant portion in margin accounts, which could create “perverse incentives” for the activist firm. Boards should evaluate the activists’ pledging practices and develop mechanisms to mitigate potential risks to the company.

Going forward, SSGA will assess settlement agreements according to how they address these issues, which will inform their voting decisions on the election of directors in activist situations. They also intend to engage with companies that pursue “unplanned financial engineering strategies” within a year of entering into a settlement. SSGA also wants long-term investors, boards and activists to “debate and together develop principles” that would protect long-term investor

interests in settlement agreements.

In [an article](#) on activism and shareholder engagement earlier this year, we foretold the possibility that as activist campaigns are resolved at an increasingly rapid rate, there could be more focus on boards that agree to those settlement agreements and “in the long term, there could be more scrutiny of companies capitulating too quickly to an activist’s demands.”

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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