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What Should Companies Do, And Not Do, During Proxy Contests?

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I focus on the intersection of government, Wall Street & main street.

The more effective response to an activist investor, generally, is for companies to be transparent with their mistakes. FOTOLIA

The influence of activist investors on corporate decision making and the capital markets is as strong as it has ever been.

In advance of what is expected to be another very busy year for shareholder activists and the companies they target, we sat down with Damien Park and Greg Taxin of Spotlight Advisors. Spotlight serves as an advisor in shareholder activism situations. In 2017, Spotlight advised more than a dozen companies facing shareholder activism including six contested board elections that went to a final shareholder vote.

Park has been an advisor in dozens of proxy contests over the last 15 years. In 2009, he became the Co-Chairman of the Conference Board's Expert Committee on Shareholder Activism and is a regular speaker at professional conferences on matters relating to effective shareholder engagement and best-in-class corporate governance structures for publicly traded companies.

After a career as a lawyer and investment banker, Taxin co-founded and served as CEO of Glass Lewis & Co., a proxy advisor to many of the world's largest investors. Taxin later managed an activist hedge fund before forming Spotlight Advisors.

Park and Taxin have been principals or advisors in more than 75 shareholder activist situations.

Christopher P. Skroupa: What are some of the biggest mistakes companies have made during a proxy contest with an activist?

Damien Park: I would say one of the worst things a company can do is disregard an activist's recommendations or treat them with contempt. Management and board members must remain objective and unemotional when analyzing an activist's perspective and requests for change.

It's important to establish a constructive dialogue in an attempt to gain a better understanding of their concerns and to determine if a resolution can be obtained before a full-blown, costly and distracting proxy contest ensues. Ignoring an activist's demand for change just simply isn't an option. Suing an investor is almost always a bad idea. Adopting a poison pill, changing advance notice provisions and implementing other governance changes to thwart an activist shareholder are also generally bad ideas.

Companies engaged with activists are, in our experience, better served by providing transparent, honest disclosures about the board's rationale for its decisions and actions. Explaining how value will be created with the current strategy, capital allocation plan, management team, and incentive compensation structure is usually more productive than ignoring an activist or disparaging them.

Greg Taxin: Another mistake I've seen too many times is the misreading, or misunderstanding, of broad shareholder sentiment. Shareholders have a long history of telling management what management wants to hear. The human instinct to avoid confrontation, or the desire to preserve access to the company's leadership, drives this behavior. As a result, many times, management develops a false sense of shareholder support.

We were involved in one situation recently where the Board believed all of the Company's top 20 shareholders were very supportive of the company and its direction. The activist knew otherwise. Shareholders are much more likely to be transparent and honest with one another than with management. When the final vote came in, nearly all of those top 20 shareholders voted for change. The board was stunned.

It is also critical for boards to recognize that the company's directors are the ultimate target of these campaigns. Directors should be involved in setting the strategy and tone of engagement because, in the end, it is the directors' professional reputations that are on the line. We have been involved in situations where Boards were not fully engaged initially and ended up regretting that later on.

But, by far, the biggest mistake we have seen is when a company assumes that any idea originating from outside the boardroom must be ill-conceived. We certainly don't believe that activists are always right, but they usually aren't entirely wrong either. So, the most important thing we tell our clients is to have an open mind, consider the input of the activist objectively and don't assume that all of their ideas are faulty.

Skroupa: When does it make sense for a director to be involved in the process?

Taxin: Early and often.

Conventional wisdom had been to keep directors away from shareholders. We usually advise otherwise. Shareholders now expect to have a regular dialogue with the company's directors, and board members should be willing to engage with them.

Of course, there are important rules-of-the-road for these discussions and not every director is well equipped to handle such a conversation. However, investors, in general, look to directors to represent their best interests and to protect their investment, and if they want a discussion with a director or the full board, the board should try to accommodate that request. A threatened proxy contest is certainly not the time to hide the company's most important fiduciaries.

We have seen effective directors, time-and-again, disarm and defuse potential shareholder activism by being knowledgeable and open minded. We generally recommend that a well-prepared director be involved in overseeing the company's response to a shareholder activist all along the way. Very often, the board's voice is more powerful than management's voice at convincing the activist, and the other shareholders, about the merits of the company's plan.

Park: We believe directors should not only be regularly informed and attentive to the process, but actively engaged, exercising objective contemplation and analysis of the activist's demands. As Greg said, we encourage our clients to make directors available to large shareholders before, during, and after an activist encounter.

Skroupa: When is it effective to "attack" the activist?

Park: Rarely. We recommend companies only take this approach if the substance of the argument and the motives of the activist are demonstrably bad for other shareholders. Tossing out old, tired canards like the activist's nominees are "hand-picked," or the activist is a "short-term investor" with "unclear motives," or that the board "questions the true motivations" of the campaign, are no longer effective. They have been overused and institutional shareholders turn off when they hear these rote responses.

Taxin: That said, we were involved in a contested election this year where the motives of the activist were evident and clearly not beneficial to the rest of the company's shareholders. At our suggestion, our client did not hesitate to inform its shareholder base of the lack of alignment. The messaging was objective, fact-based and pointed. And, in the end, we believe it was very effective at winning over nearly every institutional investor in the election.

Rather than attacking the messenger, a more effective approach, generally, is for companies to be transparent with investors, recognizing and meeting head-on any performance challenges and missteps in the past. Institutional investors do not expect perfection. When companies refuse to acknowledge mistakes and insist that they have all the right answers, they lose credibility.

We advise our clients to instead describe why they've made the choices they have made and discuss the differences in operating models, strategies and performance compared to peers. To be effective and credible leaders, boards are better off acknowledging performance challenges and countering an activist's demands with a clear plan for fixing them. Shareholders expect a substantive response to criticisms and suggestions. Ad hominem attacks on an activist investor will rarely advance the cause. Respond on the merits. Ultimately, substance will win.

Skroupa: I assume these contested meetings take a real toll on a company. Is this a safe assumption?

Park: They really do. It's hard to overstate the all-consuming nature of proxy fights. They are distracting for management, the costs are high and organizational resources get diverted from important daily operations. They are also emotionally charged. We've unfortunately witnessed a few instances where professional and personal relationships among directors and managers have suffered as a result of an activist campaign.

Taxin: When I was an activist investor, identifying undervalued companies and running proxy fights was my primary job. However, corporate leaders and directors have a business to manage. In some ways, it is really an unfair fight. It's similar to a dedicated, full-time, professional athlete battling a person with a full-time day job – the proverbial weekend warrior. Avoiding such battles is generally a good idea if middle ground can be found. That said, there are a lot of things worth fighting for. But companies should not expect the fight to be an easy one.

I work with institutional investors and fund managers in the U.S., Europe and Asia on issues involving asset allocation, risk management, corporate governance, active investing and socially responsible investments. I focus on the intersection of government, Wall Street and m... MORE

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