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Underwriters of D & O and Professional Liability Insurance

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In this issue … *we look at activist shareholders and their relationship with the companies they invest in.*

ACTIVIST SHAREHOLDERS: WHITE KNIGHTS, OR BARBARIANS AT THE GATE?

An activist shareholder can generally be defined as a shareholder who: 1) owns a significant amount of a company's stock, 2) has strong opinions on how that company should be run and the direction of the company's strategy, 3) challenges the company's management to implement the activist's ideas and plans, and 4) is usually willing to take active steps to achieve those aims, including seeking seats on the board. Unsurprisingly, this generally puts activist investors in direct conflict with company executives and directors.

While certainly a threat to incumbent management, activist investors are different from other threats posed in the late 20th century. Those included the "asset stripper" who sought to gain control of a public company and then dispose of the assets separately for total proceeds greater than the cost of acquisition; the "greenmailer," who bought large quantities of company stock, and then forced the company to buy it back at a premium to make the greenmailer go away; and the leveraged buy-out specialist who embarked upon corporate takeovers, often hostile, using vast amounts of borrowed money, hence the "leveraged" tag. The seminal case study for this was the 1988 acquisition of RJR / Nabisco, whose fascinating story was recounted in the book "Barbarians at the Gate."

Activist investors however, while they may set up a clash with incumbent management, generally do not want to gain ownership of the company, seeking rather to maximize the value of their investment through partnership with management, albeit a rather uneasy one.

WHOSE COMPANY IS IT ANYWAY?

Public companies may be owned by their shareholders, but practical and regulatory considerations limit just how much control the "owners" can have. A public company needs full-time managers and executives to operate the enterprise —hopefully as best they see fit for the benefit of the owners. Even the best intentioned management team will sometimes get it wrong, but application of the "Business Judgment Rule", a judicially created doctrine that affords considerable latitude to executives deemed to be acting in good faith, has been recognized in several jurisdictions, including the Court of Chancery of the State of Delaware, home to the greatest number of public company incorporations.

Years ago, shareholders were generally content with a passive ownership role, clipping their dividend coupons if lucky enough to receive them, or mostly suffering in silence if the company was not doing well. The rise of the activist investor has altered that dynamic; no longer content with looking on from the sidelines, activists are grabbing the mantle of ownership and demanding a greater say in the running of their company.

REPELLING MARAUDERS

However much activist investors claim they are acting for the good of the company and its shareholders, corporate executives tend to view activists as the latest iteration of unwanted and unwelcome assaults on the

company in general and executives in particular. Public companies have a history of adopting tactics to repel such attacks. The "poison pill" mechanism which emerged in the 1980s was intended to create unpalatable consequences for hostile acquirers should they succeed. In recent years, defensive measures against aggressive plaintiff lawsuits have included adoption of forum selection provisions intended to limit shareholder lawsuits to specific jurisdictions, and initiatives to limit the ability of outside shareholders to nominate candidates for election to the board.

Another stratagem has received prominent attention in recent weeks:

Pulling the Debt Trigger provision

A piece in the Wall St. Journal (WSJ) on April 28 noted that since the start of 2014, nearly 200 companies have created new loan agreements with their lenders that force companies to accelerate the repayment of the debt if a certain number of directors are ousted. According to the WSJ article, such provisions have resulted in at least ten lawsuits against companies and lenders in recent months. One such dispute cited by the article involved Healthways Inc. and its lender SunTrust Banks Inc.: the case was settled only after the debt triggering provision was removed. Other lenders appear to be pulling back: Bank of America is believed to have phased the requirement out of some credit arrangements.

Yet other companies and lenders continue to feel such provisions are reasonable and warranted: if the individuals who negotiated a loan on behalf of a company have been replaced by others whose actions might imperil the borrower's dependable repayments or even the borrower's credit rating, then a lender is justified in requiring accelerated debt repayment to protect its interests.

But activist investors tend to see such arguments as disingenuous, and that these debt-trigger provisions are really a ploy to erect barriers to forcing a change of board membership that activist investors often seek to achieve. One thing seems clear: the clash over these contentious provisions will simply add another item for primary D&O carriers to consider.

Comment

Few people relish criticism, and when that criticism is made noisily and publicly by activist investors seeking change, it is welcomed even less. But as noted above, the days of shareholder deference to corporate management are largely gone. Moreover, the spotlight that shareholder activism can shine on a company's operations, expenses, and strategy might not always be unhelpful.

In a February 7, 2015 commentary, *The Economist* proposed the idea that activist investors are actually good for the public company, and faced with these "Wall Street provocateurs, America's lazy money is waking up," that "The public company was never meant to be a bureaucracy run by distant managers… The activist revolt will help give it a new lease of life."

On May 13, the giant DuPont Company succeeded —after a close vote— in getting all of its sitting directors re-elected, a rejection of the efforts of activist investor Nelson Peltz and his Trian Fund Management to secure board membership. While clearly a setback for shareholder activism, even some of the large shareholders who supported DuPont felt that the conflict was ultimately beneficial for the company.

An analyst from fund manager Jensen Investment Management —that voted its 1.87 million shares in support of the company— commented: "As a result of this, [DuPont] is a little bit stronger, better, more focused."

The struggle also spurred DuPont to state its case by directly engaging with major shareholders. These efforts were appreciated by at least one investment firm, Mawer Investment Management Ltd., with a holding of around 900,000 shares. Setting up a call with the firm, DuPont made the Chief Financial Officer and a board member available to explain its performance and strategy in person. "We ended up siding with management," said a representative from the investment firm, adding that "they [DuPont] have done a lot of the stuff they said they were going to do."

Such direct contact and lobbying of shareholders by the company may of necessity become more frequent: simply suggesting on the proxy voting form that shareholders vote to reject a proposal may not be enough. The market data provider FactSet has calculated that in 2014 activist investor campaigns numbered 347, up from 219 in 2009 —and 2014 was a year when the S&P 500 share index gained some 12 percent over the 12-month period. It is not unreasonable to expect that a period of falling stock prices will encourage even more investor activism. ❖

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