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Proskauer Benefits Brief: Activism and EBEC

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In this episode of The Proskauer Benefits Brief, David Teigman, partner in the Tax Department and a member of the Employee Benefits & Executive Compensation Group, Josh Apfelroth, partner in the Private Equity and Mergers & Acquisitions Group and Nick LaSpina, senior counsel in the Employee Benefits and Executive Compensation Group discuss shareholder activism in the public company context and more specifically within the framework of executive compensation. Because executive compensation can be a hot-button topic for shareholders and can be implicated in a variety of activist situations, be sure to tune in for the latest insights into these matters.

David Teigman: Hello and welcome to The Proskauer Benefits Brief: Legal Insight on Employee Benefits and Executive Compensation. I'm David Teigman, partner in the Employee Benefits and Executive Compensation Group at Proskauer, and with me today are my colleagues Josh Apfelroth, a partner and a member of our Mergers & Acquisitions group, and Nick LaSpina, who is a senior counsel in our Employee Benefits and Executive Compensation Group. Welcome to you both.

Josh Apfelroth: Good to be here.

Nick LaSpina: Great to be back!

David Teigman: Today, I wanted to talk about shareholder activism generally in the public company context, and then more specifically within the framework of executive compensation. Josh, if you wouldn't mind, could you give us a brief overview of what exactly shareholder activism is?

Josh Apfelroth: Sure. Shareholder activism is where a shareholder of a company advocates for certain changes at the company that shareholder believes will drive value. In the industry, these are sometimes called activist “campaigns.” These campaigns come in many different flavors, and shareholders utilize a variety of different strategies in seeking to influence target companies. To start, it’s important to note that activists come in many different forms — some are activist hedge funds or multi strategy funds whose primary business is to identify situations that are ripe for activism and seek to proactively make an investment in a company with a view towards running a campaign. Others are existing investors in companies that find themselves in a position where they disagree with the company’s approach and determine to do something about it through the use of activism strategies.

David Teigman: What types of strategies do activists tend to employ in seeking to achieve their goals?

Josh Apfelroth: While there are, of course, differing viewpoints with the respect to shareholder activism and its role in the economic landscape, I’d like to start off with the general premise that a shareholder activist’s objectives are generally aligned with that of the company and the other shareholders of the company: to increase the value of the company and correspondingly benefit from an increase in the company’s stock price.

Now, the debate among stakeholders is typically around how best to achieve these objectives. Activists often do a significant amount of work prior to making an investment in the company to identify areas where they believe its intervention could result in enhanced shareholder value. These investment theses can span a broad range of topics, such as a push to sell the company or enter into other transformative transactions, management changes, operational efficiencies, capital allocation, governance improvements, opposition to material transactions, board refreshment and many more. I think it’s important to note that the tactics available to activists in seeking to achieve these goals are not a one size fits all approach. While ultimately, the most powerful tool at the disposal of an activist is the ability to nominate and elect directors to a company’s board, and these are the situations we often read about in the newspapers, activists are often able to achieve their objectives using tactics that fall short of a full-fledged proxy contest, either through private dialogue, submission of stockholder proposals, public pressure or settlements with the company.

David Teigman: That’s helpful, Josh. I suppose any shareholder could become an activist shareholder, but in reality, isn’t the amount of the shareholder’s holdings important?

Josh Apfelroth: Yes, to an extent. As a threshold matter, a shareholder should own a large enough stake in the company to make expending the costs and committing the resources of running a campaign worth it for them. In other words, since the ultimate objective is to improve a company’s stock price, an activist shareholder will want to meaningfully benefit from the increased stock price through its stake in the company. That threshold might be different for different shareholders, but in any case, it needs to be met. Second, the larger a shareholder’s stake in the company, the more seriously the company and its shareholders will take them and the more access they will likely receive in communicating their views. This is mainly because the shareholder with a larger stake will have a head start at the ballot box in a potential proxy contest and has exhibited that they have “skin in the game,” which aligns their interest with those of the other shareholders. That said, so long as those threshold matters are met and particularly in an era where index funds run by large institutional investors are the dominant shareholders at almost all public companies, whether one is successful in an activist campaign ultimately comes down to the relative strength of the party’s arguments, its effectiveness in communicating them and its ability to build consensus among its fellow stockholders and stakeholders.

David Teigman: That makes sense. Josh, could you give us a sense of the market with respect to activist campaigns? That is, over the last decade or so, have activist campaigns generally been increasing?

Josh Apfelroth: Look, I think it's safe to say that activists and activism have very much become a fixture in the economic landscape and that they aren't going anywhere. Since 2018, the number of companies that have annually been subject to activist campaigns globally has hovered around 1,000, and there is no company too small or too big to become the target of activism. Household names such as Microsoft, Proctor & Gamble, Exxon and many others have seen attention from activists. At Proskauer, we represent both companies and stockholders in connection with activism. We work with activist funds, as well as the occasional activist, and advise on strategies that range from less adversarial to full blown proxy contests. We also represent companies in defending against these tactics. We can tell you from experience that the number and types of shareholders that are willing to pursue activist strategies are only increasing.

David Teigman: I see. So, how do you see employee and executive compensation issues intertwined with activism?

Josh Apfelroth: As you know, executive compensation is always a hot button topic for shareholders and it can be implicated in a number of different ways in an activist situation. The most common way you see it highlighted is where a shareholder identifies outsized executive compensation or compensation packages or packages that don't properly align executive interests with company performance as an example of the board's poor stewardship. This will typically be one of a number of arguments raised by the shareholder in an effort to highlight the need for board refreshment or management change. Less common, but still present, are activist campaigns where executive compensation or employee matters are the central issue under the microscope. You might see this come to light in campaigns focused on a company's "say on pay" proposal or other stockholder proposals related to executive compensation or labor matters. You may have recently seen the activist campaign at Starbucks which was focused on alleged anti-union tactics. Some thought that the enhanced access brought about by adoption of the universal proxy rules would give rise to more single-issue contests raised by special interest groups of this type, but that hasn't really come to fruition. You will also sometimes see change of control triggers in employment agreements or incentive plans come into play in circumstances where a change in board composition will result in significant payouts to management, which an activist may argue serves to improperly entrench board members. There is a recent Delaware case involving Masimo that calls this issue into question.

David Teigman: Thank you, Josh. That's a helpful segue to executive compensation aspects of activist campaigns. Nick, if I could turn to you, have you been involved in any activist campaigns where a central strategy of the campaign related to executive compensation?

Nick LaSpina: Yes, several, with both smaller and larger public companies.

David Teigman: Okay, great. In your experience, what is the general philosophy of these campaigns with respect to executive compensation?

Nick LaSpina: Simply put, the activist may think that the current leadership of the company is not steering the company in a way that is maximizing value for shareholders. In these cases, sometimes the activists have even partnered with executives who have had a proven track record in the same industry as the target company with the idea that the existing management team could be replaced relatively quickly with a team that the activist has partnered with.

David Teigman: That makes sense at a high level in terms of driving management changes. Moving more granular, could you share your insights as to what other executive compensation related changes might be sought by an activist?

Nick LaSpina: Sure, Dave. Executive compensation programs can drive action at a company. That is, certain performance metrics being used in an equity compensation program or bonus program can incentivize certain behaviors by executives and employees who are seeking to achieve target metrics, which translates into earning bonuses or vesting into equity. The hope is that these results, in turn, drive shareholder value. So, it's not uncommon for activists to seek to revamp an executive compensation program. For example, an activist may highlight that year over year modifications in annual bonus performance metrics do not include sufficiently rigorous changes that are substantially more difficult to achieve than corresponding metrics in the prior year's program, and so the activist may argue that the program is not adequately designed to encourage sufficient growth.

That said, consistent with Josh’s thoughts, it is rare in my experience for executive compensation itself to be the sole or even a primary target in activist campaigns. Activists may highlight questions or criticisms they have in a company’s compensation programs, but those tend to be utilized to underscore the broader business critiques that the activist is seeking to make. Activists should also be attuned to the fact that overly criticizing an executive compensation program may put the activist in an awkward position if, for example, the activist succeeds in orchestrating a turnover of a company’s board, and then finds it difficult to incentivize, retain or recruit talent without spending as much as — if not more than — the company did on executive compensation prior to the change.

David Teigman: That’s helpful, Nick. Pivoting to focus on the defensive side of activism — what can a company do to help executives feel more secure in their roles when facing an activist that is targeting management?

Nick LaSpina: Good question, Dave. You are correctly pointing out that executives that are being targeted by an activist may have trouble focusing where the executives may be removed in short order if the activist wins a substantial number of board seats in a proxy fight. In this case, the board should consider what might make the executives continue to focus on day-to-day management and not on the proxy fight or its potential consequences. The most often used compensation tool in this case is enhanced severance. That is, if not already in place, the board could seek to provide some sort of enhanced severance plan so the executives recognize that even if the activist succeeds in its proxy fight and ultimately is able to convince the board to terminate the executives, the executives will at least have market level severance protection in place if and when they are terminated following the campaign.

This can be easier said than done, of course. Companies have a tough balancing act here — boards need to be mindful of the disclosure obligations that come with making changes to a company’s executive compensation program. Disclosure of enhanced severance packages or other increases in compensation during or proximate to a proxy fight may provide an activist with additional fodder and, to be frank, may not be flattering for the board or existing management. That disclosure can also draw the attention of proxy advisory firms as well, who may view enhanced severance as off market or potentially even a “problematic pay practice” that could feed into a recommended “no” vote against the company in the proxy contest or otherwise.

David Teigman: Thank you, Nick. Josh, from your perspective, is there anything else we should mention about the compensation issues that might arise in an activist campaign?

Josh Apfelroth: As Nick alluded to, it's important for companies to be proactive in thinking about its approach to executive compensation and people matters. They should be in fairly regular communication with important shareholders and stakeholders, including proxy advisory firms, and conduct proper benchmarking to support a record of adequate oversight. It's important to remember that activist campaigns are in many ways similar to political campaigns — the ultimate objective is to persuade shareholders to vote a certain way. So, don't forget that PR matters. Large compensation payouts combined with stagnating share prices might alone become a persuasive hook for an activist to agitate for change. Therefore, a company needs to be prepared to defend its, defend its compensation program and explain why it is actually effective.

David Teigman: Josh and Nick, thank you so much for this informative discussion about shareholder activism generally and specifically in the context of executive compensation. Activism is part of the economic landscape, and it appears to be here for the long haul, so these issues will continue to be highly relevant. Thank you also to our listeners for joining us on The Proskauer Benefits Brief today. Stay tuned for more insights on employee benefits and executive compensation, and be sure to follow us on Apple Podcasts, Google Podcasts and Spotify.

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