

Legal Update

Activism and the Outbreak: How Activist Investors – and the Companies They Target – May Respond to the COVID-19 Pandemic

Key Takeaways:

- In the early stages of market reaction to the current COVID-19 pandemic – similar to the early stages of the 2007-2009 financial crisis – it is likely that activist investors will increase their activity to take advantage of company valuations that have moved sharply lower in a short period of time.
- However, a prolonged market downturn – especially one that is driven or accompanied by a lengthy economic downturn and limited availability of capital for activist funds – may slow or reverse any increase in activist activity.
- In the near term, public companies should consider addressing the increased potential activist threat through a combination of proactive measures to be taken in advance of an activist attack and options that may be deployed on short notice in response to such an attack.

Introduction

The sharp, sudden stock market downturn of March 2020 in response to the COVID-19 pandemic will likely create opportunities for activist investors to obtain stakes in companies at substantially lower valuations than just a few weeks ago. Companies that are facing the unique challenges of operating their businesses during the current pandemic may now be faced with the additional challenge of fending off activist investors.

In this article, we will discuss this emerging risk by considering historical precedent and looking forward to some practical suggestions for addressing the current risk. First, we will review some data from the 2007-2009 financial crisis that we believe is instructive to understanding the state and potential direction of the current markets. We will also offer some reasoned comparisons between the current crisis and the financial crisis and discuss possible ways that activists may respond to the current crisis. Next, we will review practical steps that companies can take now to prepare themselves for activist campaigns that may arise in the near term.

A Look Back: Activism During the Financial Crisis

According to data compiled by FactSet, the first half of the financial crisis – the second half of 2007 and the first half of 2008 – saw a sharp increase in the number of activist investor campaigns. In fact, the number of campaigns in 2007 rose to a level that was not seen again until 2015. In its commentary on the market at the end of 2007, FactSet reported that the fourth quarter of 2007 had been the busiest in terms of newly announced activist campaigns in recent memory and one of the most active quarters ever. While there were likely multiple factors driving the increase in activist campaigns during this period, one of these factors was undoubtedly the onset of the bear market and the attendant decreases in stock prices.

However, as market conditions continued to deteriorate in the second half of 2008 and 2009, numerous activist campaigns were abandoned and new ones failed to materialize. As credit markets ground to a halt and investors withdrew significant amounts from activist hedge funds, there was much less capital available to pursue activist investments. In addition, as market uncertainty increased and more companies were threatened by the prolonged economic downturn, there may have been less appetite among shareholders for the types of disruptive changes pursued by activists.

In addition, throughout the financial crisis, activist investors targeted companies across sectors. Data from FactSet, ISS and other sources indicates that certain sectors – including consumer discretionary and information technology – were some of the most popular targets for activists. But sectors such as financials, healthcare and industrials also received considerable activist attention during this time. One takeaway from this data may be that activists were less concerned with sectors and more concerned with companies' prospects for generating cash flow (or other fundamental attributes) and opportunities to agitate for changes that would produce rapid returns.

A Look Ahead: Does History Repeat Itself?

While history often offers lessons for the future, no two crises are the same. Based on reasoned comparisons to the financial crisis, we believe that activist activity may evolve in six key ways:

- 1. Near-term increase in activist activity based on valuations** The recent precipitous declines in stock prices only amplify the power of the activist war chests currently available and are expected to lead to a near-term increase in activist activity. This increase, however, may be followed by a reversal and ultimately give way to a decrease in activist campaigns. This decrease will be more likely if market and economic conditions become depressed and remain so for an extended period of time, and if credit market conditions lead investors to withdraw capital from activist hedge funds, as they did during 2008 and 2009.
- 2. Activists may target prospects based on valuation rather than sector** Any increases in activism are likely to target companies across sectors, although this activity will likely be focused on sectors that have historically attracted activist attention. In particular, companies particularly hard hit by the pandemic may not be more or less likely to be targeted by activists. Rather, activists will continue to be opportunistic and target companies at attractive valuations that have issues activists believe they can address.
- 3. Certain fundamentals – such as companies' cash positions – may be viewed as favorable rather than indications of inefficiency** Some company attributes that would ordinarily attract the attention of activist investors may be particularly valuable to a company in the current environment. For

example, companies that have large net cash balances may find that cash to be extremely useful in weathering a prolonged downturn caused by the COVID-19 pandemic. In the past, these companies might have been targeted by activists claiming that excess cash was not being used efficiently. As such, an attribute that may have previously been perceived as a vulnerability that might draw activist attack may now be viewed as a strength that is attractive to all investors (activist or otherwise).

- 4. It remains to be seen how public perceptions of activism in this environment will impact activity** It is unclear whether public perceptions of campaigns in the current environment will influence activist behavior – in terms of both the number of campaigns conducted and the nature of the campaigns and changes sought by activists. For example, some activists may be reluctant to be perceived as taking advantage of such a tragic situation outside of companies' control. At the same time, it seems unlikely that activists will press "pause" on their activity altogether. Rather, it seems more likely that activist campaigns may take different forms or seek more nuanced or narrow changes in companies, as we describe in the next item.
- 5. Activist theses will incorporate the effects of the pandemic** The COVID-19 pandemic might add a new gloss on activist theses that were prevalent to date. For example, M&A activism, which typically seeks a sale or break-up of the company or challenges an announced transaction in order to obtain better terms for shareholders, might be influenced by lower outlooks or projected performance or market prices of companies due to the effect of the pandemic. This might result in an activist challenging the deal price (agreed to by the board of directors of a company) on the basis that it does not represent full value for the company because it reflects an excessive discount for the effect of the pandemic. Alternatively, an activist may press for a sale of a company given the activist's negative view of the company's condition as a result of the pandemic, while the board and management believe that the company will weather the pandemic in better condition and that a sale would be ill-timed. Similarly, operational theses, which emphasize changes in the company's business to unlock value, might take into account a company's financial performance as a result of the pandemic (especially relative to its peers) and seek to bring about change based on the perceived failure of company management to prudently navigate the pandemic.
- 6. Activists may target companies with relatively small market caps** Following over a decade of increasing activity and number of activist investors, many large companies have either been targets of activists already or have taken measures to make themselves less attractive to activist investors. As a result, activists may find more opportunity – in the form of corporate governance issues and other opportunities – in companies with relatively small market caps, which market caps are likely diminished at current stock prices.

Preparing for Shareholder Activism During the Pandemic: First Steps

Because the circumstances of companies and the nature of activists vary widely, there is no universal detailed list of steps to take to prepare in advance for every possible activist approach precipitated by the COVID-19 crisis. However, there are certain initial steps that a company can take to best position itself to respond if and when it becomes the target of an activist arising out of the current pandemic.

First, engage in honest self-reflection. Take a hard look at your businesses and circumstances with the assistance of investment bankers, counsel and other outside advisors from the perspective of an activist. Are there aspects of your company that are likely to draw the attention of an activist? What are your vulnerabilities?

From a performance perspective:

- consider how your stock is performing as compared to the general market and to peers in the current environment,
- confirm whether your company has established a well-thought-out strategy on how to manage the impact of COVID-19 *and* whether you have clearly articulated the strategy to the investment community as well as begun to execute against it,
- observe how peers are responding to the pandemic in different ways, and whether you might emulate any of their actions,
- identify any acquisitions or other decisions that an activist may focus on and criticize,
- understand your underperforming businesses and/or non-core assets that might lead to an argument that divestitures should be made, including whether there are any unique challenges to your business that have been exacerbated by COVID-19,
- review any criticism from analysts or other negative press, in particular in relation to your response to the pandemic, and
- consider whether there are ways in which an activist could see an opportunity during or shortly after the pandemic to effectuate quick changes to drive a short-term impact your market value.

More generally, from a management perspective:

- analyze your level of debt and/or excess cash (and consider whether you have clearly articulated to the investment community any related plans), as well as compare your levels to those your peers are maintaining in the current environment,
- identify any corporate governance matters that may be improved, including any ISS recommendations against directors or any shareholder proposals received,
- understand the perceptions of your management team and directors and the relationship between the management team and the board, and
- consider your board composition, including whether any individuals have stayed too long, whether the board has the correct skill set necessary to guide your company through the pandemic and, more generally, the diversity expected for a public company in your industry and whether the board has an appropriate level of independence from management.

Second, in addition to monitoring public filings generally, carefully watch for increases in trading volume compared to historical volume and, in particular, compared to peers in the current environment, any new trading firm becoming a top trader of shares (particularly when the firm is typically used by activists) and/or accumulations by activists, hedge funds or new institutional shareholders. Any of these may be an indication that an activist is accumulating shares.

Third, review your corporate organizational documents and agreements to determine whether changes should be made to strengthen your ability to deal with an activist. Consider, for example, whether you should modify your advance notice by-law provisions applicable to shareholder proposals or director nominations. Also consider having a shareholder rights plan “on the shelf” and available for adoption on short notice (noting, however, that a poison pill may be of limited value in dealing with an activist that does not seek a large stake in the company).

Finally, focus on and cultivate your relationships with your shareholders, analysts and the media. Ensure that throughout the pandemic you maintain and further strengthen a robust communication

strategy in order to build and maintain your credibility across these relationships, as activists are generally more likely to target companies that are poorly understood and/or subject to public criticism. One of the best defenses to an activist attack is to have a long-term strategy that is supported by your shareholders and is publicly communicated clearly and often by management. As a result, consider how your long-term strategy is impacted (or not) by COVID-19 and communicate your understanding and course correction (if any). Take the further step of identifying and cultivating key supporters through this crucial time – whether institutional investors, sell-side/industry analysts, customers, important business partners, government officials or other regulators, business/trade organizations and other advocates, but particularly institutional investors, as activists seek to gain the support of institutional investors to further their cause. In rolling out your pandemic-specific and general communication and cultivation strategy, consider whether independent directors should be involved with or potentially lead some or all of your meetings. It may allow those involved to speak more freely about their views on your company and management in the current environment and beyond, benefiting the company further by having promoted a more independent and objective open line of communication.

For more information about the topics raised in this Legal Update, please contact any of the authors or any other member of our Corporate & Securities practice.

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