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Activists in Your Boardroom: Planning for and Managing the New Dynamic

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Shareholder activists continue to infiltrate the boardroom with unprecedented frequency, whether by proxy contests or favorable settlements implementing board change. Dissident board challenges have been met with increasing success during the past several years, culminating in record-high success rates during the 2014 and 2016 proxy seasons of 73 percent and 60 percent, respectively. On average, approximately two directors have come on board through each successful activist proxy contest or settlement over the past three years.

While the question of whether to accept nominees from activists is always dependent on the circumstances and the nominees, it is more important than ever for executives and directors to be prepared for and have strategies in place to ensure the effective evaluation, selection and integration of activist directors. Planning for the possibility of an activist director is useful in the long run, both for the board and for the company's shareholders. There are a number of steps every company can and should take to ensure that if activism does arise, the board is prepared to evaluate those candidates. Specifically, the board should do so in a manner that is most likely to be respected by courts and institutional investors, and assures that if the nominees are designated to the board, that board governance will be conducted fairly and efficiently.

Review Bylaws, Policies and Procedures

Perhaps the most important preparation for activist directors is to review and, if necessary, revise the governance procedures embedded in the bylaws and policies of the company. While many companies conduct

such reviews in an effort to prepare to defend a proxy contest, it is equally important to prepare for the possibility that the company will opt to settle a contest or will not be successful at the ballot box and activists will force their way onto the company's board. The important thing to bear in mind is that it is best to implement any changes to governance on a "clear day." In the context of a proxy contest, or even settlement discussions with an activist, changes to bylaws, committee structure, board qualifications, confidentiality agreements and the like, while appropriate, may garner more judicial or other negative attention, or be rejected by the activist in the context of the settlement. Instead, spending time at your next board meeting to both review these matters and make bylaws or other policy changes is appropriate and will generally serve a board well in its ability to maintain fairness and effectiveness in the boardroom.

To ensure effectiveness of the board process if an activist director joins the board, governance procedures and policies should be tailored to maintain the stability of the board and the company, and to ensure that a single director or a small minority will not have disproportionate influence on the affairs of the company and the board. For example, consider the procedure for calling a board or committee meeting (or in rare cases, special meetings of shareholders). Many companies have one or two directors capable of calling a board or committee meeting, but that is not necessarily ideal in the context of an activist director. Such a policy may enable disruption of an effective board process by placing the agenda and timing of meetings in the hands of a single director or a small minority, rather than in the hands of the board as a whole. We suggest that the power to call meetings rest in the hands of the chairman or three or more directors, or even possibly the majority of the board.

Board committees are another place to undertake a proactive review. Companies should ensure that board members are well distributed among committees and that each committee is led by a chair who has the ability to manage both the agenda and the strategies of that committee in the face of less than conciliatory relationships. Companies should also review whether the delegation of authority to each committee is clear and evaluate whether a committee has too broad or too narrow power in the context of new directors joining the committees. To constrain the influence of a minority of directors, be sure that committee chair selection is handled by the full board, rather than the committee members themselves.

The ability of committees to function independently is also important in the context of activist directors. Board participation in committee meetings is important, and there are a number of companies that effectively invite all of the directors to attend committee meetings as observers. That practice can have benefits both from the use of time perspective and in terms of keeping all the directors well informed. But in the context of a boardroom that becomes perhaps less collegial or with a broader divergence of views, the ability to have committees function independently and meet on their own is generally preferable. This is a particularly important practice to adopt on a "clear day," as it may be difficult to articulate a reason why the board is changing that practice after activist directors come on the board.

Confidentiality policies are essential to any board, but are particularly important in the context of an activist director; they should be implemented if not in place, and updated periodically.

Maintaining the confidentiality of boardroom discussions is essential to maintaining trust and confidence among directors and facilitating a productive and deliberative board process. Clarity concerning what information may be shared, and with whom, is essential in any confidentiality policy. However, particularly where the designated director is an employee or principal of the activist fund, the contents of discussions among directors, or even corporate information provided to the directors, may not be covered by a common law duty of confidentiality or loyalty. Out-of-date policies may also have undesirable gaps.

One should also review the procedures for communications between the board and management, employees and shareholders. This is a particular concern if principals of an activist fund, who tend to hold a different view of information flow and access to employees, join the board as directors. Multiple channels of communication between the board and employees can consume time and effort and create disruption and uncertainty in the workforce. Granting authority to manage the timing and reasonableness of such board communications to the chairman or a special committee will ensure that each director has equal access to information and may help control the board process. While the Delaware Court of Chancery has observed that a director's right to information is "essentially unfettered," reasonable process restriction should be permissible. Having a *pre-existing* procedure in place whereby the chair or a committee has the ability to manage that process can be useful in garnering judicial respect for such procedures.

Evaluating and Onboarding Activist Nominees

It is important for companies to recognize that activist nominees may be an asset rather than a disruptive force. Nominees are increasingly independent and often possess experience applicable to the company's industry. Nominees should be evaluated in terms of the fit of their skills and experience in the context of the skills and experience of the board in its entirety, and how that aligns with the company's strategic direction and operating profile.

Regardless of whether a company pursues a proxy contest or a settlement with an activist nominee, the company should evaluate the nominee to determine the activist's fit with the board and to identify their possible objectives as a director. Companies should endeavor to run their standard candidate screening and due diligence process for activist nominees, including by conducting background checks and vetting nominees with current board members. The timing of the settlement of contests may not always enable such screening, but if undertaken when the nominees first emerge in the contest, adequate time should be available, and it will arm the board for thoughtful discussions with the activist and other institutional investors on the weaknesses and strengths of the nominees.

In the event of a settlement, there are a number of factors to consider regarding the implementation of the director's term. First, will the director be brought on board immediately or at the next annual meeting? If the board is staggered, which class should the new director join? It is important to consider both the practical and optical implications of these questions. Additionally, companies should consider whether the board should be expanded or if a director should be replaced. These decisions may turn on whether the nominee is a "monitor" or a "change agent." In the former case, the board may wish to seek an agreed resignation of the director when the plan or actions that have been agreed upon with

the activist, and which the director is present to witness, have been completed or substantially completed.

Additional drivers of agreed resignations or term limits include: (1) a reduction in the activist stake below a specified level; (2) the duration of the activist agreement to "standstill" as to activism regarding the company; and (3) separation of the director from the fund if they were employed by the fund at time of settlement.

Finally, settlement discussions often involve agreed committee appointments for the designated directors. These should be thoughtfully considered both from the perspectives of the experience that the designee brings to the board, and the potential such appointments may present for undue influence on the functioning of the board and management, whether due to the mandate or the makeup of the committee.

Establish and Maintain Clear Boardroom Procedures and Structures

Once a director designated by the activist is in a company's boardroom, the company should try to benefit from that director's skills and expertise while maintaining control of the boardroom. Activist designees in the current environment are often well-qualified with experience relevant to the company's current circumstances, and in many cases have no prior experience as an activist designee. The board should welcome the new director with a focused and positive board orientation, setting the tone for activist interactions with incumbent board members and demonstrating to the activist(s) that their views will be heard while also informing the director(s) of important boardroom policies, procedures and rules. It may also be valuable and necessary to prepare incumbent board members in advance for this positive and inclusive approach.

In order to maintain control over the board process, it is preferred that the board hold meetings in person until the new directors become acquainted with the incumbents—unruly directors may be easier to control in person than by telephone.

Finally, the company should continue to provide board education on fiduciary duties and possible conflicts of interest in order to ensure ongoing compliance by incumbent and activist directors. Directors should be reminded that feedback from all shareholders is considered in decisions, not just the views of activist or significant shareholders.

Conclusion

To best serve their company and its shareholders, incumbent directors and executives should acknowledge the likelihood that activist directors may be a part of their future, and plan accordingly. If activist designees do join the board, the terms of their tenure, role in board process and integration with the board culture should be carefully considered and managed in order to maximize the prospects for that appointment ultimately benefiting the board and shareholders.

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