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Activist Investors Fighting The Conventional Board Standing

by Christopher P. Skroupa - Contributor
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Jeroen van Kwawegen is a partner at Bernstein Litowitz Berger & Grossmann LLP, where he specializes in representing investors in disputes with boards of directors and senior management. BLB&G's "governance department" has a remarkable track record and reputation representing institutional investors and activist funds in breach of fiduciary duty actions and appraisals. These actions may involve mergers & acquisitions, corporate misconduct , and the protection of shareholder franchise rights, including the fundamental right of shareholders to elect their representatives on the board of directors.

Christopher P. Skroupa: How do you define your mission in regard to shareholders' rights?

Jeroen van Kwawegen: My job is to protect shareholders' three fundamental rights: the right to sell shares, the right to effectively vote shares, and the right to hold fiduciaries managing investor money accountable for misconduct. Protecting those rights is essential for ensuring the integrity of boards and management. From our perspective, most boards and management act in good faith and do a good job. However, in some circumstances, there is an inherent conflict between the personal interest of directors versus the interests of shareholders. We become involved if directors favor their personal desires over the interests of shareholders. For example, there is an inherent conflict of interest between directors who want to maintain their office and shareholders who may want to vote them out. We will become involved if directors use their corporate powers to, for example, change bylaws or enter into significant credit agreements with dead hand proxy put provisions to protect their board seats at the expense of shareholder voting rights.

Skroupa: What corporate governance trends and issues are driving your current work on behalf of your institutional clients?

Kwawegen: Our work often concerns basic human impulses, such as greed, vanity, and self-preservation. That will never change. The most recent manifestations of those impulses have led us to focus on protecting shareholder voting rights. For example, we have challenged "dead-hand" proxy put provisions in corporate credit agreements that would put the company in default of its credit obligations if shareholders ousted a majority of the board. Such provisions were widespread and served no purpose other than insulating boards from accountability to their shareholders. Similarly, we have challenged boards who rewrote election rules in the corporate bylaws in order to hinder or undermine activist investors.

Skroupa: How do companies respond when shareholder voting rights are utilized?

Kwawegen: Boards of directors are given broad powers, subject to their fiduciary duties. Part of that power is to adopt and change bylaws that provide the administrative rules for the company's internal governance. The board of directors might use its power to amend bylaws to fight off an activist by making it more difficult for the views of all shareholders to be heard and for all shareholders to nominate directors. In other words, some boards abuse their corporate powers to entrench themselves in a fight with an activist by impairing the fundamental voting rights of all shareholders. This of course, is improper. If a board believes that its strategy is better than the strategy proposed by an activist, it should communicate

its views (using corporate funds) and trust that shareholders will agree and vote the activist proposal down.

Darden Restaurants is a good example. A few years ago, Darden owned a number of restaurant chains, including Red Lobster, Olive Garden, Capital Grille, and a couple of others. An activist investor made a detailed proposal to unlock shareholder value by placing the mature restaurant chains such as Red Lobster and Olive Garden in one company and the newer, higher growth restaurants such as Capital Grille in a separate company – each with their own specialized management – while Darden's significant real estate holdings would be sold to a Real Estate Investment Trust. Darden's board disagreed with the proposal and informed shareholders that they instead planned to sell Olive Garden. This is a perfectly legitimate dispute over the strategy of the company and from a legal perspective there was no "right" answer. Another activist investor then informed the Board that it would call a special meeting of shareholders to solicit their views and that if those views were ignored it would run a proxy contest to oust the Board. In response, the Board changed the bylaws to give the chairman extraordinary powers to suspend shareholder meetings and to make it more difficult for shareholders to hold meetings and nominate directors.

Skroupa: What type of jousting goes on behind the scenes to get the bylaws fixed? How does that process go when the shareholders don't see things going their way?

Kwawegen: If there is already a conflict between one or more shareholders and a Board that is entrenching itself, it will usually take a credible threat of a lawsuit to get the bylaws fixed. That is also what happened in Darden, where we filed a lawsuit and ultimately, after the old board was ousted, were able to undo the bylaw amendments that harmed the voting rights of all shareholders.

Skroupa: How important a role does litigation play in shareholder engagement?

Kwawegen: In my experience, litigation is an arrow in the quiver of shareholder engagement that should typically be used as a last resort. The threat of litigation to enforce investor rights positively affects the balance of power between boards and the shareholders whose interests they are supposed to protect. When we do bring a lawsuit, the stakes are high and the potential impact on shareholder rights is significant. For example, we just brought a lawsuit challenging a $50 million loan facility that a financially distressed controlling stockholder Navios Maritime Holdings ("Holdings") imposed on its healthy subsidiary, Navios Maritime Acquisition ("Acquisition"). The loan was on absurd terms and served no purpose other than to transfer value from Acquisition up to Holdings at the expense of Acquisition's stockholders. After we filed a complaint and injunction papers and the Court scheduled a hearing, Holdings capitulated, terminating the loan. Smart litigation preserved $50 million for Acquisition's stockholders.

Skroupa: How often are companies open to working with you and making the process less adversarial? How does your work differ from and overlap with the established shareholder activists?

Kwawegen: The majority of companies fairly engage with their shareholders. And in those cases, my firm does not become involved. We become involved if the process breaks down and Boards decide to use their corporate powers to insulate and entrench themselves for their personal benefit or to benefit the interests of a dominant stockholder over the interests of public stockholders. That is the exception not the rule. But in those exceptional circumstances, Boards are usually not inclined to make the process less adversarial–at least initially–because they are already in an adversarial situation. After we explain the basis for a potential lawsuit, they often understand that we are not taking sides in the underlying business dispute and are merely seeking to protect the interest of all shareholders. That understanding can form the basis for discussion to resolve the dispute, but the company and its advisors have to get over their instinct to fight us no matter what we do.

Skroupa: How can shareholders defend their voting rights when boards use entrenchment devices to preserve themselves?

Kwawegen: First they need to object. Having effective voting rights is fundamental to being a shareholder. But if objecting does not work, they should consider hiring counsel to increase the pressure, especially if the entrenchment devices are implemented while there is a dispute between shareholders and the board. Boards cannot insulate themselves from accountability by impairing fundamental shareholder rights.

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