A Conversation with Keith E. Gottfried, Proxy Contest Defense Counsel

Interview by Adam J. Epstein

Keith E. Gottfried is a mergers and acquisitions (M&A) partner at the law firm of Alston & Bird LLP and head of its company-side shareholder activism defense practice. He advises public companies, their boards, and special committees on proxy contests, consent solicitations, activist shareholder campaigns, and other contests for corporate control. While his client base covers an array of industries and company sizes, his shareholder activism defense practice is focused on small-cap companies. Over the course of a legal career that spans more than two decades, Gottfried has been involved in defending numerous companies against proxy contests and other activist shareholder campaigns.

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Why might activists target small-cap companies?

Last year was busy for those of us who focus our practices on defending public companies against activists, and we saw numerous common themes raised by activists. In many of the proxy contests I defended in 2013, while the activists might have used company financial, operating, and stock price performance and corporate governance issues as the building blocks for rhetorical messaging, their principal motivation appeared to be to unlock shareholder value that they thought would be released by either a sale of the company or a sale of a business segment or other assets. Activists were also often pushing for some type of event that would facilitate liquidity for a generally illiquid stock. In pursuing a proxy contest to gain minority representation on the board, the activist would argue that it had no faith in the board as currently composed to effect a value-maximizing transaction, thus justifying the need for change in the board's composition.

Are there unique elements to small-cap activism?

In my experience, small-cap companies tend to be very vulnerable to activists for a number of reasons. Their small market capitalizations make it easier for an activist to acquire a significant position—in some cases more than 10 percent—and easier for an activist to recruit other activists so as to, formally or informally, assemble a "wolf pack." Small-cap companies tend not to be as well prepared as larger companies for an activist attack. Many small-cap companies tend not to appreciate the importance of regular bylaw reviews, and often their bylaws don't reflect the latest thinking on provisions relating to advance notices of proposals and nominations, director qualifications, and the process by which shareholders can call special meetings or take action by written consent.

In addition, small-cap companies may have directors on their boards with qualifications that won't stack up against the nominees that the activist might recruit for its proposed slate. Small-cap companies may also not be sufficiently mindful of where they stand with the proxy advisory firms and, to their detriment, may have ignored years of withhold recommendations, not realizing the consequences that this would have if a proxy contest were to be launched by an activist.

Another vulnerability issue with many small-cap companies is that they are sub-scale—that is, it is hard to justify that they should continue to be independent public companies and continue to absorb the overhead associated with being publicly listed instead of being sold or merged into a larger company.

What are the warning signs that a company might be a target of an activist shareholder?

One early sign is unusual trading volume. Many small-caps have relatively low daily trading volumes. When that volume inexplicably spikes, it could mean that an activist is in "accumulation" mode. Companies should monitor the trading in their stock, and any new, significant accumulations should be reviewed. Companies should not wait until a Schedule 13D is filed to determine whether an activist has acquired 5 percent of their stock. Companies should also review their shareholder profile on a regular basis to assess whether there are any new significant holders that have track records of mounting activist campaigns. A proxy solicitor can be particularly helpful here, given its familiarity with many activists, as well as those that may be likely to invest in a parallel fashion.

What should a company and its board do if they suspect they could become targets?

If a company suspects that it has become a target, it should quickly assemble a "fight" team. Such a team should include, from the company, the CEO, CFO, general counsel, and director of investor relations, and externally, the company's regular securities counsel, special proxy fight counsel, and a proxy solicitor. While the company may have very competent securities counsel, such counsel may not necessarily be experienced with defending public companies against proxy fights and other activist campaigns. In such a case, the company should consider retaining special proxy contest counsel to be complementary to the existing securities counsel.

In most of the proxy contests I got involved in last year, I served as special proxy contest counsel alongside the company's regular securities counsel, which was often a nationally recognized firm. In some cases, the company might want to consider including a public relations firm as part of the fight team. The board should be actively engaged as well. Once the team is assembled, the company should perform an assessment to determine where the company would be vulnerable if the activist decided to proceed with a proxy contest or other activist campaign.

At the same time, the company, with the assistance of counsel, should determine what additional defenses, if any, should be considered for adoption. I don't advise companies to adopt every defense available, but the menu of options should be presented to management and the board, and in considering which defenses to adopt, companies need to consider how such defenses would be reacted to by institutional shareholders and the proxy advisory firms.

Keith E. Gottfried

Another action item I recommend early on is that companies review their shareholder profile and begin assessing how they would fare if the annual meeting were held tomorrow under various scenarios—such as if a proxy advisor firm supports or opposes management.

Outside of activism, per se, what are the most common corporate governance deficiencies you see at small-cap companies?

For many small-cap companies, corporate governance is not a major priority. Unlike some large-cap companies that have in-house legal departments that may include corporate governance specialists who can devote time each year to updating corporate bylaws, committee charters, and governance guidelines and recommend other actions to stay current with best practices in corporate governance, many small-cap companies don't even have one in-house lawyer.

In addition, while large-cap companies are often subjected to pressure from large institutional holders to adopt best practices in corporate governance, that pressure often does not get applied to small-cap companies. As an example, most small-cap companies don't receive Rule 14a-8 shareholder proposals calling for some type of corporate governance enhancement, such as the elimination of a staggered board, the adoption of majority voting in uncontested elections of directors, the separation of the chairman and CEO positions, and an expanded right of shareholders to call a special meeting. As such, you continue to see numerous small-cap companies with staggered boards, plurality voting in the election of directors, and the positions of chairman and CEO held by the same individual.

I see numerous small-cap companies where little attention is given to enhancing the composition, functionality, and accountability of the board. In my experience, small-cap companies are less willing to hire a recruiting firm to identify new director candidates, and, as such, new director candidates, if any, may come from a limited network. Board diversity is also an issue that is not given sufficient attention at small-cap companies. D