

Trian Launches Proxy Contest Seeking Board Seats at DuPont—Some Considerations for Small- and Mid-Cap Companies

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Challenges to incumbent boards and managements by activist investors were common in 2014. With the announcement on January 8, 2015 that Trian Fund Management, L.P. (“Trian”) is nominating a short slate of four candidates for election to the board of directors of E. I. du Pont de Nemours and Company (“DuPont”)—a company with a current market capitalization in excess of \$66 billion—this trend is likely to continue in 2015. Moreover, Trian’s proxy contest with DuPont illustrates that not just small- and mid-cap public companies that have underperformed their applicable index are vulnerable to aggressive shareholder activism; shareholder activists also target large-cap public companies that have outperformed the S&P 500 index.

Following the activist hedge fund Starboard Capital LP’s (“Starboard”) sweeping October 2014 victory in which the shareholders of Darden Restaurants Inc. (“Darden”) removed all 12 of Darden’s incumbent directors and elected an entirely new slate of directors nominated by Starboard[‡], many commentators predicted that aggressive shareholder activism and challenges to incumbent boards and managements would continue in the future. Trian’s proxy contest proves those predictions to be accurate.

Trian’s Proxy Contest

After engaging in private dialogue with DuPont’s management and lead director for more than a year, Trian sent a letter to DuPont’s management on September 16, 2014, setting forth Trian’s belief that DuPont’s conglomerate structure is destroying shareholder value. In particular, Trian criticized DuPont as an inefficient conglomerate characterized by (i) excessive holding company costs (including ownership and maintenance of the 1,252 seat DuPont Theatre), (ii) disparate businesses and overwhelming complexity, (iii) bureaucracy and lack of accountability, (iv) an inefficient capital structure, and (v) a persistent conglomerate stock price discount.

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[‡] For more information regarding Starboard’s sweeping victory, please see “Landmark Win for Activist Shareholder—Some Lessons for Boards and Managements,” available at <http://www.koleyjessen.com/resources/landmark-win-activist-shareholder-lessons-boards-managements/>.

DuPont attempted to rebut Trian's concerns by pointing out that, (i) through September 16, 2014, DuPont has delivered 220 percent total shareholder return since year-end 2008 versus 144 percent for the S&P 500 during the same period, (ii) DuPont had recently announced a redesign initiative to drive costs down by \$1 billion and imbed greater efficiencies, (iii) DuPont had announced plans to spin-off its performance chemicals business, and (iv) DuPont has a \$5 billion share repurchase plan in place.

Despite its relatively strong stock price performance and initiatives designed to drive shareholder value, DuPont was unable to persuade Trian that DuPont has not been underperforming and, on January 8, 2015, Trian reiterated its concerns set forth in its September 16, 2014, letter and launched a proxy contest by announcing it had nominated a short slate of four directors for election at DuPont's 2015 annual meeting. On January 12, 2015, in response to the Trian's criticisms, DuPont announced that it had agreed to sell the DuPont Theatre.

Some Lessons for Small- and Mid-Cap Companies

In the current economic environment, it is more important than ever that boards of small- and mid-cap public companies (with market capitalizations less than \$10 billion) take steps to avoid having their companies "put in play" by activists. The following are some steps that boards should consider to lessen the likelihood that their companies will be put in play:

- Routinely monitor and review the company's strategy, capital allocation, and businesses in light of potential activist arguments for spinoffs, share buybacks, increased leverage, special dividends, a sale of the company or business unit, or other fundamental changes.
- Regularly engage in meetings with institutional shareholders to seek open and honest feedback regarding the company's direction. These meetings should ideally include independent directors.
- Maintain a unified consensus on key strategic issues, and otherwise assure that vigorous and open boardroom debates over business strategy, direction, and other matters remain within the boardroom.
- Periodically schedule presentations by counsel and/or investment bankers to familiarize themselves with the then-current activist environment as well as the direction of the financial markets.

While taking steps, boards should also proactively plan for the possibility that their companies will be put in play. The following are some steps that boards should consider to prepare for an activist attack:

- Create a core response team consisting of a small group of key executives (*e.g.*, chief executive officer, chief financial officer, general counsel, investor relations officer) plus advisors, including legal counsel, financial advisors, proxy solicitor, and public relations firm that is ready to quickly respond to any activist attack.

- Review the company's structural defenses and defensive profile to determine what, if any, steps can be taken to make the company less susceptible to an activist attack.
- Work with legal counsel to prepare a shareholders rights plan that can quickly be adopted by the board if the need arises because of an activist attack.

Note that these actions should be taken with a view to preserve and maximize the board's and management's flexibility in responding to any activist attacks and permitting the board and management to act in the shareholders' best interests. This is important because any actions that are perceived by the shareholders, proxy-advisory services, and other market participants as further entrenching the board and management are likely to cause more consternation among such participants, and may even prompt an activist attack. A continuous dialogue between the board and its legal, financial and public relations advisors that enhances the board's understanding of the company's financial position and prospects is far more valuable than an off the shelf "one-size-fits-all" response plan to a hostile or activist investor.

Conclusions

Trian's proxy contest to elect a short slate of directors to DuPont's board illustrates that even large-cap companies with relatively strong stock performance are not insulated from aggressive attacks by activist shareholders. Launching a shareholder activism campaign at the scale of Trian/DuPont requires relatively large amounts of capital. However, small- and mid-cap public companies are particularly susceptible to activist shareholders. These companies are vulnerable in part because they may receive unsolicited bids from both strategic and financial players, including and in particular, aggressive entrants to the activist market.

Given the amount of liquidity in the markets, the significant amount of "dry powder" capital available to activist investors, and the relatively smaller amount of capital required to build and maintain a stake in such companies, small- and mid-cap public companies remain particularly vulnerable to activist shareholder attacks. As such, small- and mid-cap public companies, with the assistance of their legal counsel, should conduct a comprehensive review of their defensive profiles to assess and understand their vulnerabilities and what defense mechanisms are available.

A superficial "check the box" analysis may be convenient and inexpensive. However, such an analysis may fail to uncover subtle vulnerabilities in a company's defenses. For example, the protections of a staggered board are severely weakened if shareholders can unilaterally expand the size of the board and fill the newly created vacancies. Similarly, in the case of a Delaware corporation, a bylaw purporting to limit the ability of shareholders to act by written consent is ineffective unless the corporation's charter sets forth the restriction. As such, defensive provisions written in a certificate of incorporation or bylaws should be carefully reviewed by legal counsel to determine their enforceability and potential loopholes.

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