CEOs, Constructivist Activists Clash at Small Caps



Certain C-suite and director dynamics at smaller companies often drive constructivist activists into ugly and avoidable boardroom battles, activism experts said.



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While large- and mega-cap proxy fights often dominate headlines, the greater volume of shareholder activism takes place in the small-cap space — where the potential for returns is often higher and where governance battles are often uglier, experts participating in a Thursday, Jan. 22, CommPRO Worldwide webinar said.

The ugliest proxy fights often erupt at small caps led by founders who view activists as "interlopers" in businesses they consider their own, noted Seward & Kissel partner Randall Adams.

Sometimes, in these cases, the board is accused of having grown accustomed to deferring to the judgment of founders because the whole company, including any products it produces, was their creation, Adams explained.

"That doesn't serve the board well when it comes to the actual proxy contest, when it comes to litigation" where directors are forced to admit under oath that they simply deferred to the founder, he said. "And if your answer to every question is that the founder CEO knows how this works or I usually defer to this person," that doesn't create a great record for a director's professional reputation, Adams continued.

This type of so-called "imperial CEO" dynamic, where boards are accused of effectively delegating oversight to dominant founders, is more commonly seen at small caps, and it clashes with the increased use of "constructivist" activist strategies, panelists said.

The Friction

While constructivist activists purport to prefer private, friendly dialogue, the structural rigidity of an "imperial CEO" may render that approach impossible, leading to an escalation that includes hostile proxy fights, experts said. Further, institutional investors are often commonly willing to hear constructivist activists out and are often less swayed by aggressive tactics or bellicose rhetoric, noted Leonard Wood, partner and chair of Goodwin Procter LLP's shareholder activism and takeover defense practice.

For constructivist activism to work, the investor needs a counterpart on the board who is willing to listen and negotiate. Ideally, there is an independent director with the

"gravitas" to engage without personalizing matters, explained Lawndale Capital Advisors Inc. adviser Andrew Shapiro.

But in an "imperial CEO" scenario, the board has abdicated its oversight role by overly delegating even its fiduciary responsibilities to the C-suite, he added.

Because the "imperial CEO" structure blocks the independent dialogue necessary for a constructivist settlement, the activist is forced to abandon private dialogue and launch a public fight, Shapiro said. In these cases, the goal tends to shift from debating strategy to a structural "transfer of power" where the activist feels like it must replace the board to create a "level playing field," he added.

The "imperial CEO" dynamic may be more prevalent at small companies, but it isn't unique to them. The same dynamic is frequently seen at family-controlled companies, noted Brendan M. Foo, partner and global head of corporate contests at Forward Global. Family-controlled company boards often lack true independence, populated instead by long-time associates who are socially beholden to the family rather than focused on objective governance, he explained.

A tell-tale sign that a board is subservient to the C-suite is when an activist raises executive compensation as an issue and the board directs them to speak with the CEO about it, Lawndale's Shapiro said. This is the "red flag of red flags" because a constructive negotiation about pay cannot happen with the recipient of that pay, he added.

The Activist Vaccine

Since small capitalization companies are generally less prepared for activist investors than large caps, it is critical for smaller companies to move quickly to prepare for an activist investor's escalation, including identifying structural vulnerabilities and attack vectors and understanding the activist's agenda, explained Gottfried Shareholder Advisory LLC CEO Keith Gottfried.

"The clock is already against the small cap," Gottfried added, noting that a thoughtful, well-planned, strategic response to the activist could be outcome determinative.

For small caps, Lawndale Capital Advisors' Shapiro advises boards to administer an "activist vaccine" designed to improve the "functional health of the boardroom" before a hostile party publicly emerges.

This preventative regime rests on four pillars: establishing independent governance, refreshing board composition to align with future strategy, enforcing disciplined capital allocation and maintaining candid investors communication, he explained. Ultimately, this type of proactive approach deprives activists of "oxygen" and costs a fraction of the financial and reputational damage caused by a public fight, he added.

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