LATIN LAWYER INSIGHT

The Guide to Corporate Crisis Management

Second Edition

Editors
Sergio J Galvis, Robert J Giuffra Jr and Werner F Ahlers

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Publisher's Note

Latin Lawyer is delighted to publish *The Guide to Corporate Crisis Management*.

Edited by Sergio J Galvis, Robert J Giuffra Jr and Werner F Ahlers of Sullivan & Cromwell LLP, and containing the knowledge and experience of over 40 leading practitioners from a variety of disciplines, it provides guidance that will benefit all practitioners when an unexpected crisis hits.

Corruption investigations, expropriation, industrial accidents: corporate crises take many forms, but each can be equally dangerous for companies in Latin America. Covering the impact of political instability, the role of communications in crisis response, approaches to bribery investigations and game plans in response to financial stress, this book is designed to assist key corporate decision-makers and their advisers in effectively planning for and managing corporate crises in the region.

We are delighted to have worked with so many leading firms and individuals to produce *The Guide to Corporate Crisis Management*. If you find it useful, you may also like the other books in the Latin Lawyer series, including our *Guide to Infrastructure and Energy Investment* and jurisdictional references.

My thanks to the editors for their vision and energy in pursuing this project and to my colleagues in production for achieving such a polished work.

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Crisis Management as a Tool for Approaching Shareholder Activism

Sergio J Galvis and Werner F Ahlers[1]

Shareholder activism is on the rise around the world, including in Latin America. As the focus and tactics of activists evolve, companies and their directors can draw on crisis management techniques and strategies from the United States to prepare for activist campaigns.

Few events test a company's board and management like the appearance of an activist investor. An activist campaign, like many crises, often arises unexpectedly, unfolds swiftly and can lead to dire consequences, including threatening a company's very existence. Every step a company takes can be fraught with implications. How management and the board respond to an activist's demands – from public statements to private boardroom strategy sessions – may well determine their company's future and define their legacy.

Once a phenomenon contained to the United States, shareholder activism is expanding across the globe. Last year, companies outside the United States constituted 47 per cent of the known activist targets, and the number of companies that grappled with activist investors reached record highs in Australia, Canada, Japan and the United Kingdom.[2] Worldwide, 226 companies were publicly targeted in 2018, a 20 per cent jump over the prior year. Companies in Latin America are also not immune from this phenomenon.

In light of recent developments, companies in Latin America and their boards of directors should reevaluate historic shareholder relations models, as well as traditional approaches to responding to shareholder initiatives. One of the best ways to analyse this complex area is to examine the lessons gleaned from US companies that have faced activist campaigns. Their use of crisis management tactics in particular provides a blueprint for anticipating and managing the landscape of shareholder activism as it reaches Latin America.

1 Sergio J Galvis and Werner F Ahlers are partners at Sullivan & Cromwell LLP.

2 *Activist Investing Annual Review 2019.*

The unique challenge of shareholder activism

Broadly speaking, shareholder activism is the practice of purchasing an issuer's shares with the primary intention of influencing corporate strategy or governance. Activists generally focus on companies with vulnerabilities, including poor financial performance, perceived board entrenchment, corporate governance practices that are not aligned with current best practices and a lack of responsiveness to shareholders.

A key reason that shareholder activism can be so challenging is that, like many high-stakes games, it is often unpredictable. Activists' objectives vary. Most demand more profitable operations, which may take the form of a proposal to divest or separate divisions. Some activists may insist on a change in governance, such as the separation of the roles of chief executive officer and chairman, or new policies for director remuneration. More drastically, they may seek a sale or merger of the company.

Activists tend to be strong personalities, marked by unique brands of strategies and techniques. Some take a less hostile approach and aim to drive change through private dialogue with management. Others tend to make more noise. They initiate high-profile public campaigns – including personal attacks on directors and management – designed to pressure boards. They may launch a proxy contest, seeking to elect a slate of directors or force specific actions. Threatening or filing litigation to challenge board actions is another option in their toolkit. Occasionally, they make an offer for the entire company.

Their playbooks can also be influenced by the size of their funds and their level of expertise as an activist. Other factors can include the fund's position in its fundraising cycle, its historical financial performance, and the timing for limited partners to redeem their capital.

In all of these scenarios, a company's board, management and advisers must attempt to anticipate the next move of the activist's chess piece.

An uptick in shareholder activism in Latin America

Activists have been paying increased attention to Latin America, with seven Brazilian companies experiencing reported activist campaigns and one in Mexico in 2018. This year, at least two campaigns have taken place. While these numbers may seem relatively low, directors of Latin American companies should not be complacent or feel insulated from this phenomenon.

One of the earliest examples of activists targeting a Latin American company is Cartica Capital's attempt to thwart Chile's CorpBanca SA's US$3.7 billion merger with Brazil's Itaú Unibanco Holding SA in 2014. Cartica, a US investment firm, took the aggressive step of filing litigation in the United States to stop the merger. Last year, Mexico's Aeroportuario del Sureste, an airport operator, was challenged by Standard Life Aberdeen, one of the world's largest asset managers, which sought to eliminate the company's two tiers of stock by calling an extraordinary shareholders meeting.

While the activists in these campaigns were not able to entirely achieve their goals, at least one more recent activist campaign in Latin America has had more success by taking direct aim at management. This year, the CEO of Brazilian healthcare management company Qualicorp SA stepped down under pressure from Brazil's XP Long Biased FIM fund.

Similarly, Brazilian telecommunications carrier Oi SA has battled this year with its largest shareholder, GoldenTree Asset Management, over the fate of its CEO.

Of course, the corporate environment in Latin America differs from that of the United States, where shareholder activism had its most significant early development. In the region, governance and disclosure regimes vary by country. One key difference that many Latin American companies share is that they are controlled by shareholder blocks centred around families or other affiliations, a dynamic that can make an activist campaign less likely to succeed.

In addition, the shareholders of Latin American companies generally tend to exercise more direct control over boards of directors and their decisions. As a result, shareholders of Latin American companies seeking change can turn to existing corporate mechanisms to influence the board in ways that may not be available in the United States without resorting to activist tactics. In some Latin American jurisdictions, for example, shareholders holding as little as 5 per cent of a company's share capital may be allowed to call a special meeting.

Another difference is that Latin American securities markets operate with less liquidity, which reduces the appetite of activists who may struggle to sell shares they amass. Finally, Latin America is a complex patchwork of markets of different sizes and laws requiring potential activists to develop specific knowledge about a target's market. Mexico is very different from Colombia, which is very different from Argentina, and so on.

The role of institutional shareholders in Latin America

In any activist campaign, institutional investors often play an influential role owing to the activist courting them for their support. Before a campaign emerges, a company's board and management must draw up a plan to identify, analyse and communicate with its largest and most vocal shareholders.

Most activists hold only a small stake in target companies and rely on the support of large institutional investors to gain traction in their campaigns. For instance, for US campaigns launched in 2018, the median percentage ownership of the activist investor was approximately 7 per cent and less than 2 per cent in companies with a market cap of over US$20 billion. As retail ownership of public companies declines and institutional ownership increases, activists can rapidly garner support from other shareholders with less engagement and lower costs. In addition, activists may also enlist increased support from institutions due to a shift in investment philosophy: many retail investors are shifting away from active investment strategies and relying more on passive holdings, such as index funds, leaving activists with more concentrated holdings.

Index funds are increasingly investing in Latin American companies, reflecting the broader trend of investors seeking more exposure to emerging markets over the past decade. In addition, many countries in Latin America have a pension system comprised of privately managed pension funds for both private and public sector employees. These funds represent one of the largest and most predominant types of minority investors and have the potential to play a role similar to that of institutional investors in the United States. Although these funds have historically weighted their funds heavily (if not exclusively) toward government bonds, over the past decade these funds have expanded their investment profile to include equity securities.

For example, corporate and government retirement income systems in Peru have currently allocated 51 per cent of their funds to equities, the highest level in Latin America. Other country's retirement systems also have significant funds invested in equities: Colombia: 39 per cent; Chile: 32 per cent; Mexico: 22 per cent; Brazil: 18 per cent; and Argentina: 14 per cent.[3]

The rise of the ESG agenda in Latin America

In the United States, more activist investors have been focusing on environmental, social and governance (ESG) matters, and some are gaining traction. For instance, in 2017, the powerful institutional investors BlackRock, Vanguard and State Street backed a proposal requiring ExxonMobil to share more information about its climate-related plans and the proposal passed. Some activists are creating special funds to focus on ESG and other similar initiatives. US corporate leaders are taking this movement seriously. In a major shift in policy, the Business Roundtable in August announced its commitment to the principle that corporations should consider the interests of stakeholders other than shareholders. In a statement signed by 181 CEOs, the group committed to consider the well-being of their employees and communities as well.

In Brazil, the ESG movement has already developed into a significant consideration for companies' boards. Glass Lewis, the influential proxy advisory firm, recently changed its guidelines for Brazil to codify its approach to reviewing how boards are overseeing environmental and social issues.

Under its new stance, Glass Lewis has made it clear that it will take into account a board's handling of these issues. Its 2019 Guidelines for Brazil state:

> *In instances where it is clear a company has not properly managed or mitigated environmental or social risks to the detriment of shareholder value, or when such mismanagement has threatened shareholder value, Glass Lewis may consider recommending that shareholders vote against members of the board who are responsible for oversight of environmental and social risks.*[4]

Issues unique to the Latin American sociopolitical climate may also shape the profile of shareholder activism in the region. Environmental advocacy groups, for example, have urged companies operating in Latin America to adopt rainforest conservation policies to protect endangered lands.

Crisis management lessons from the US experience

As activists become more prolific and sophisticated, companies around the world are looking to their counterparts in the United States for lessons on preparing for an activist

3 Mercer, 'Growth Markets Asset Allocation Trends: Evolving Landscape 2019'.

4 Glass Lewis, 2019 Guidelines, Brazil, 3, 8–9.

campaign. In recent years, many targeted US companies have shifted their tactics. In the past, boards tended to respond reactively to activists, by shunning them or engaging in minimal interaction. Today, many companies have achieved more productive results by implementing a proactive strategy in which a board is prepared in advance to respond to a potential campaign.

To help Latin American companies and their advisers anticipate and respond to shareholder activism, we have outlined below some key observations, tactics and strategies gleaned from the US experience, including the importance of applying techniques and strategies from crisis management. In every situation, the options available for responding to shareholder activists will depend on the circumstances. Even small variations may require different responses.

Assemble and educate the team

A well-prepared company will assemble a core response team, including internal personnel and external advisers who can address legal, financial and public relations issues. This team will be tasked with analysing governance trends and the evolving activist landscape. Its members must communicate effectively and, if necessary, frequently with management and the board.

It is also essential to prepare the board by having management and advisers regularly update directors on possible activist lines of attack and the company's anticipated responses. Activism readiness should be given a regular spot on the annual board calendar as part of board discussions on strategic planning and capital allocation. Advisers should also periodically review executive compensation and stock option plans for change-of-control provisions.

Think like an activist investor

One of the best ways to anticipate an activist campaign is to adopt the mindset of an activist investor. A company's attractiveness as a target and its ability to respond turn on many factors, including its capitalisation, the identity of its shareholders, its recent returns and its media profile. As an initial step, a company needs to identify areas where it may be vulnerable. Does its balance sheet present weaknesses, such as a shortage of cash? Could its governance practices and succession plans be attacked as promoting entrenchment? Is the company's business strategy and financial performance sound?

If a company is targeted by an activist, it should carefully consider its response plan and resist the urge to reflexively strike back. It also should take into account the identity and track record of the activist, and, most importantly, the nature and attractiveness of the activist's proposal.

For example, in the United States, activist investor Daniel Loeb of Third Point LLC is known for occasionally aggressive public tactics, such as releasing sharply worded letters criticising boards and management. This year he has taken aim at Sony, calling for a breakup of the company, and also opposed the merger of United Technologies Corporation with Raytheon Company. In a letter to the board of United Technologies, he called the merger 'ill-conceived' and 'irresponsible' and described the company's rationale for the deal as a 'word salad' that was short on substance.[5]

Paul Singer of Elliott Management, on the other hand, while not afraid of public proxy contests, often prefers to achieve a settlement rather than put a proposal to a shareholder vote. In 2017, he reached a deal with industrial parts maker Arconic that gave Elliott Management three board seats and included an agreement to make corporate governance changes, rather than continue a public battle.[6] In March 2019, Singer struck a deal with eBay in which the company agreed to add two new directors and undertake a strategic review of its business.[7] Comparatively, Nelson Peltz of Trian Partners prefers to be known as a 'committed shareholder' that tries to work with boards of directors. Last year, after he launched a proxy battle for Procter & Gamble Company and fell slightly short, the company's board invited him to join as a director.[8]

Communicate effectively

Activist campaigns can quickly spin into a war of words. With social media now a standard form of business communication, activists have more options for waging the public side of their campaigns. Twitter, Facebook and other social media platforms allow them to reach influential investors quickly and cheaply.

Companies need an effective and sophisticated media strategy focused on delivering a consistent message to the public and the capital markets. The best prepared companies formulate a response protocol and a communications response plan that is tailored to address the varying concerns of shareholders, employees and key third parties, including proxy advisory firms.

Personal conversations are also essential. Management should sit down with major shareholders to understand their concerns and communicate the company's strategic plan and mid- to long-term vision. As part of these conversations, management should explain its analysis of alternatives to create value, including previewing for investors why some activist proposals that may appear superficially appealing are not advisable.

In addition, management's public speaking appearances must be monitored to limit opportunities for inadvertent or inconsistent comments about the bidder's offer or the company's articulated strategy in response.

Understand institutional investors and their agendas

As we mentioned earlier, institutional investors are a valuable source of support in an activist campaign against a Latin American target. Compared to most activist investors, the managers of pension funds and index funds have a longer-term investment horizon, and tend to focus on improving the quality of corporate governance as a means to improving returns.

5 'Daniel Loeb's Third Point Calls for Breakup of Sony—Again', *The Wall Street Journal*, 13 June 2019; 'Third Point Sends Letter to United Technologies Corporation's Board of Directors', *Business Wire*, 28 June 2019.

6 'Arconic Settles With Elliott After Bruising and Public Dispute', *New York Times*, 22 May 2017.

7 'eBay Adds New Directors to Board and Begins Strategic Review', *Bloomberg*, 1 March 2019.

8 'Nelson Peltz Appointed to P.&G. Board, After All', *The New York Times*, 15 December 2017.

By identifying differences in an activist's focus, companies can get a head start on winning the support of institutional investors. Companies should bear in mind, however, that some institutional investors, such as the privately managed pension funds and index funds, as well as non-government organisations, may seek, as the price of their support, adherence to formulaic corporate governance initiatives or sociopolitical commitments. These may not be appropriate or advisable for every company.

Consider appropriate structures for board oversight and involvement

Boards of directors may want to take a fresh look at their role in overseeing shareholder engagement, if they have not done so recently. Some may choose to create formal committees and policies for monitoring and overseeing management's approach to shareholders, while others may expand the mandate of an existing committee.

At a minimum, the board must make it a priority to stay regularly informed of the company's shareholder outreach efforts and the resulting feedback. They will also need regular briefings on any developments in the arena of shareholder activism, including new activist techniques or strategies and evolving corporate responses to activists.

In addition, as boards have become increasingly involved in shareholder engagement, particularly with institutional investors, some activists may seek to pressure certain directors to meet with shareholders. Ultimately, the level of director-shareholder engagement will depend on the company's comfort level with particular directors meeting with shareholders. This is a big step that many boards are unwilling to consider. If a board does consider this, directors need to be trained and accompanied by legal advisers, as appropriate, before meeting with shareholders, to avoid any missteps, including the disclosure of confidential information.

The value of a well-articulated case

Every company facing or anticipating an activist campaign should make a convincing case to its investors that its current business strategy will create superior value over a near- to medium-term time horizon. This requires a careful, detailed analysis, as well as the crafting of a clear and compelling message.

EI du Pont de Nemours and Company's victory in the proxy campaign run by Trian Fund Management LP demonstrated the value of a well-articulated case, as well as the importance of effective engagement with institutional investors. When it launched its campaign, Trian sought four seats on DuPont's board of directors, arguing that DuPont's business was underperforming owing to excessive corporate overhead costs and bureaucracy, notwithstanding that DuPont had been consistently outperforming the stock market and stressing this track record to its investors. Although Trian had garnered the support of two of the most influential proxy advisory firms, DuPont's three largest institutional shareholders all voted in favour of the incumbent slate.[9] DuPont succeeded in having all 12 of its incumbent directors re-elected, defeating Trian's slate.

9 'DuPont Defeats Peltz, Trian in Board Fight', *The Wall Street Journal*, 13 May 2015.

DuPont's victory reinforces that activists will face challenges if they target companies with strong boards and management teams that outperform the market. To increase the likelihood of success, a company must also maintain proactive engagement with its institutional shareholders to counteract an activist's message.

Although shareholder activism has yet to emerge in Latin America with the same intensity as it has in the United States, the boards of Latin American companies must not be complacent. As in any crisis management strategy, preparation is paramount and could be the key to a company's survival. By learning from the hard-won experience of US companies, Latin American companies can prepare themselves to respond from a position of strength if an activist challenge arises.

Appendix 1

About the Authors

Sergio J Galvis

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Sergio Galvis is a leading corporate lawyer in the United States who is known for his cross-border work, especially in Latin America. He joined Sullivan & Cromwell LLP after graduating from Harvard Law School and clerking for the Honourable Lawrence W Pierce, Second Circuit US Court of Appeals, and has been a partner of the firm since 1991. He is a member of S&C⊠s management committee, oversees the firm’s recruiting and administrative functions and leads its Latin America practice.

Sergio has worked with clients across more than 25 countries in Asia, Europe and the Americas on hundreds of significant matters in a broad range of practices, including crisis management, criminal defence and investigations, workouts and restructurings, corporate governance, sovereign financing, capital markets, M&A and project financing. He also regularly works on OFAC compliance and sanctions issues, especially as they relate to in Latin America situations.

Werner F Ahlers

Sullivan & Cromwell LLP

Werner Federico Ahlers is a partner in Sullivan & Cromwell LLP's general practice group, whose practice focuses on a wide range of cross-border mergers and acquisitions, joint ventures, private equity transactions and corporate matters. Werner advises on a variety of corporate, project and restructuring financing matters, and in the areas of corporate governance and crisis management. He is a core member of the firm's Latin America practice, and regularly acts on equity and debt investments for strategic investors based in and outside the region, private equity, pension and sovereign wealth funds, and bank and multilateral agency lenders. His practice spans diverse sectors, including mining and metals, power and energy, real estate, infrastructure, telecommunications, healthcare and financial services.

Werner has been repeatedly recognised for his cross-border advisory work by leading legal publications, such as *Chambers* (Global and Latin America), *Latin Lawyer*, *Law360*, *The M&A Advisor*, *The American Lawyer* and *The Legal 500* (Latin America and US). Werner serves on the executive sub-committee and as chair of the Latin America sub-committee of the Cyrus R Vance Center for International Justice and as a term member of the Council on Foreign Relations. He is a native speaker of Spanish and is proficient in Portuguese.

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