What Private Equity Can Learn From Shareholder Activism - And Vice Versa?

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Introduction: Blurring Lines

Among the most fascinating developments in U.S. corporate practice over the past decade has been the incremental and reciprocal convergence of private equity (PE) and shareholder activism.

What exactly has been occurring? Amid ever-tightening competition for value generation opportunities, as well as ample amounts of available capital, each has begun learning from and adopting the tactics of the other.

PE in its most classic form is the leveraged buyout. The fund acquires its target outright to add industry expertise and implement a new business plan. The traditional activist, by contrast, acquires a minority holding as a means to influence change, typically via a proxy contest and the replacement of board members.

Both PE and activists seek to create or unlock value in the target. But the former typically prefers private discussions leading to a friendly transaction. The latter is accustomed to a highly public and hostile campaign to advance its agenda.

These lines are blurring, with numerous notable legal implications. The U.S. is at the forefront of this evolution. However, as with certain other market trends, it may only be a matter of time before Canada follows.

Convergence and Collaboration in the U.S.

U.S. PE has become increasingly inclined to acquire minority stakes in companies.[1] Similar to an activist, this investment can be made to force dialogue regarding operational or management change. Also similar to activism, this investment can be leverage to compel an eventual sale of the company, perhaps to the PE fund itself. Finally, while less common, but much in the vein of an activist, the PE fund can position for an entirely hostile and public relationship.

On the other hand, U.S. activists have become increasing comfortable acquiring larger stakes in their targets. Similar to PE, the goal may be more comprehensive control of the target than is obtained by a handful of board seats. Along the same lines, activists are increasingly agreeable to the longer term investment horizons needed to realize more fundamental progress. Indeed, activists increasingly use their initial toeholds to pursue an outright target acquisition.

So too has collaboration among U.S. PE and activists become more common. But one example is activists and PE approaching the target in tandem: the activist signals the offensive at hand but offers a sale to the PE fund as the board's opportunity to both avoid proxy warfare and retain their roles, including within PE's appealing incentive-based compensation model. Whether cooperative tactics such as these migrate to Canada will be particularly interesting to watch.

Lessons for Clients and Counsel in Canada

What are some takeaways from this reciprocal convergence for clients and counsel in Canada?
Most important is to appreciate that this evolution is occurring, and could become more common in Canada going forward. Change presents both opportunity and risk. Foresight, planning and prudence will be required to take advantage of the former and mitigate the latter.

The activist establishing a PE arm for the first time must be careful to avoid the structural impediments to dissident-type tactics typically included in classic PE limited partnership agreements. The PE fund new to activist strategies must appreciate the full spectrum of applicable securities law concerns, including regarding stake-building, trading on material non-public information and "joint actor" status.[2] Lessons for target companies are also manifest. The most immediate takeaway is being aware of these hybrid actors and the more complex dynamics their interest may bring, and to organize accordingly. On the other hand, the cross-over of PE and activism could well present opportunity for a company, such as a larger pool of potential "white squires" available to an embattled board. And these are merely a few examples. In all, added complexity will require ever-more sophisticated legal advice and industry awareness.

1 For related insights, see FASKEN's Annual Canadian PIPE Deal Point Study (June 2022).

2 For further insights regarding shareholder activism, see FASKEN's "Directors' Handbook: Shareholder Activism" and FASKEN's "Shareholder Activism in Canada: The Legal Framework" (forthcoming).