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Dealing With Activist Hedge Funds

The high level of hedge fund activism experienced in 2006 has continued in 2007 and appears to be growing. It requires attention and warrants the same kind of preparation as for responding to a hostile takeover bid. In fact, some of the attacks are designed to facilitate a takeover or to force a sale of the target. Careful planning and a proactive approach are critical. Failure to prepare reduces a company's ability to control its own destiny.

Among the attack devices being used by activists are: (a) proposing a proxy resolution for creation of a special committee of independent directors to undertake a strategic review for the purpose of "maximizing shareholder value"; (b) conducting proxy fights to get board representation; (c) convincing traditional institutional investors to support the activists' program; (d) using stock loans, options and other devices to increase voting power beyond the activists' economic equity investment; and (e) using sophisticated public relations to advance the activists' arguments.

Prevention of, or response to, a hedge fund attack is an art, not a science. It is essential to be able to mount a defense quickly and to be flexible in responding to changing tactics. To forestall an attack, companies should consider strategic and governance issues sensibly and in light of their particular needs and circumstances. Companies must regularly adjust strategies and defenses to meet changing market conditions and legal developments.

This outline provides a checklist of matters to be considered in putting a company in the best possible position to prevent or respond to hedge fund activism.

Advance Preparation

1. **Create Team to Deal with Hedge Fund Activism**
 - a. Basically the same team as the takeover response team: a small group (2-5) of key officers plus lawyer, investment banker, proxy soliciting firm, and public relations firm
 - b. Continuing contact and periodic meetings of the team are important
 - c. A periodic fire drill with the team is the best way to maintain a state of preparedness; the team should be familiar with the hedge funds that have made activist approaches and the tactics each has used
 - d. Periodic updates of the company's board of directors
2. **Shareholder Relations**
 - a. Review dividend policy, analyst and investor presentations and other financial public relations

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- b. Monitor analyst, proxy advisors like ISS, activist institutions like CalPERS and TIAA-CREF, and media reports for opinions or facts that will attract the attention of attackers
- c. Be consistent with the company's basic strategic message
- d. Proactively address reasons for any shortfall versus peer company benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers
- e. Monitor changes in hedge fund and institutional shareholder holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders
- f. Maintain regular, close contact with major institutional investors
- g. Monitor ISS, CII, TIAA-CREF corporate governance policies in that activists try to "piggy-back" on process issues to bolster argument for short-term business changes
- h. Maintain up-to-date plans for contacts with media, regulatory agencies and political bodies

3. Prepare the Board of Directors to Deal with the Activist Situation

- a. Maintaining a unified board consensus on key strategic issues is essential to success; in large measure an attack by an activist hedge fund is an attempt to drive a wedge between the board and management by raising doubts about strategy and management performance
- b. Review basic strategy and evaluation of portfolio of businesses with the board in light of possible arguments for spinoffs, share buybacks, special dividends, sale of the company or other structural changes
- c. Schedule periodic presentations by lawyers and investment bankers to familiarize directors with current activist environment
- d. Directors must guard against subversion of the responsibilities of the full board by the activists or related parties and should refer all approaches to the CEO
- e. Avoid being put in play; recognize that psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a target

4. Monitor Trading

- a. Stock watch service, Schedule 13F filings

- b. Watch for Schedule 13D and Hart-Scott-Rodino Act filings
- c. Monitor parallel trading and group activity (the activist “wolf pack”)

Responding to an Activist Approach

- 1. Responses to Non-Public Communications
 - a. No duty to discuss or negotiate
 - b. No duty to disclose unless leak comes from within
 - c. Response to any particular approach must be specially structured; team should confer to decide proper response
 - d. Keep board advised
- 2. Response to Public Communication
 - a. No response other than “will call you back” (no outright rejection; no substantive discussion—try to learn as much as possible by listening)
 - b. Assemble team; inform directors
 - c. Call special board meeting to meet with team and consider the communication
 - d. Determine board’s response and whether to meet with attacker
 - e. Avoid mixed messages
 - f. Be prepared and willing to defend vigorously and attack the attackers

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