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Dealing With Activist Hedge Funds

The 2013 proxy season saw a continuance of the high and increasing level of activist campaigns experienced during the last ten years. There have been more than 300 activist attacks on major companies during this period. No company is too big to become the target of an activist, and even companies with sterling corporate governance practices and positive share price performance, including outperformance of peers, may be targeted. Among the major companies that have been attacked are, Apple, Sony, Hess, P&G, McDonald's, ITW, DuPont, Target, Pepsi and Kraft. There are more than 100 hedge funds that have engaged in activism and they frequently gain the backing of ISS and major institutional investors, some of which have investments in activist funds. Major investment banks, law firms, proxy solicitors, and public relations advisors are now representing activists.

Hedge fund activism requires attention and warrants similar preparation as to that we recommend for responding to a hostile takeover bid. This memo is a revision of the one I did in 2007 as a supplement to my Takeover Response Checklist. In fact, some activist attacks are designed to change management or the board of the target in order to facilitate a takeover or to force a sale of the target. Careful planning and a proactive response 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 a proxy fight to get board representation (note solicitation for a short slate is very often supported by ISS and when it is, is usually successful); (c) orchestrating a withhold the vote campaign; (d) convincing institutional investors to support the activist's program; (e) stock loans, options, derivatives and other devices to increase voting power beyond the activist's economic equity investment; and (f) using sophisticated public relations campaigns to advance the activist's arguments. SEC rules do not prevent an activist from secretly accumulating a more than 5% position before being required to make public disclosure.

Prevention of, or response to, an activist 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, a company should continuously review its business portfolio and strategy and its governance and executive compensation issues sensibly and in light of its 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

- Create Team to Deal with Hedge Fund Activism

  - 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

  - Continuing contact and periodic meetings of the team are important

  - 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 generally and be particularly focused on those that have approached other companies in the same industry and the tactics each fund has used

  - Periodic updates of the company's board of directors

- Shareholder Relations

  - The investor relations officer is critical in assessing exposure to an activist attack and in a proxy solicitation. The regard in which the investor relations officer is held by the institutional shareholders has been determinative in a number of proxy solicitations. Candid investor relations assessment of shareholder sentiment should be appropriately communicated to senior management, with periodic briefings provided to the board

  - Review dividend policy, analyst and investor presentations and other financial public relations matters

  - Monitor peer group, analyst, proxy advisors like ISS, activist institutions like CalPERS and TIAA-CREF, Internet commentary and media reports for opinions or facts that will attract the attention of attackers

  - Be consistent with the company's basic strategic message

  - Proactively address reasons for any shortfall versus peer company benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers

  - 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, paying close attention to activist funds that commonly act together

  - Maintain regular, close contact with major institutional investors; CEO and CFO participation is very important

- Monitor ISS, CII, TIAA-CREF corporate governance policies; activists try to "piggy-back" on process issues to bolster the argument for short-term business changes

- Major institutional investors, including BlackRock, Fidelity, State Street and Vanguard have established significant proxy departments that make decisions independent of ISS and Glass Lewis and warrant careful attention. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision-makers and point-persons are and how best to reach them. It is possible to mount a strong defense against an activist attack that is supported by ISS and Glass Lewis and gain the support of the major institutional shareholders

- Maintain up-to-date plans for contacts with media, regulatory agencies and political bodies

- <u>Prepare the Board of Directors to Deal with the Activist Situation</u>

  - 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 and to create divisions on the board by advocating that a special committee be formed

  - Review with the board basic strategy and the portfolio of businesses in light of possible arguments for spinoffs, share buybacks, increased leverage, special dividends, sale of the company or other structural changes

  - Schedule periodic presentations by the lawyer and the investment banker to familiarize directors with the current activist environment

  - 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

  - 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

  - A company should not wait until it is involved in a contested proxy solicitation to have its institutional shareholders meet its independent directors. A disciplined, thoughtful program for periodic meetings is advisable.

  - Scrutiny of board composition is increasing, and boards should self-assess regularly. In a contested proxy solicitation, institutional investors frequently question the "independence" of directors who are older than 75 or who have served for more than 10 years

- Monitor Trading
    - Employ stock watch service and monitor Schedule 13F filings
    - Monitor Schedule 13D and Hart-Scott-Rodino Act filings
    - Monitor parallel trading and group activity (the activist "wolf pack")

The Activist White Paper

- The activist will frequently approach a company with an extensive high-quality analysis of the company's business that supports the activists recommendations (demands) for:
    - Return of capital to shareholders through share repurchase or a special dividend
    - Sale or the spin-off of a division
    - Change in business strategy
    - Improvement of management performance
    - Change in executive compensation
    - Change in governance: add new directors designated by the activist, separation of CEO and Chairman, declassify the board, remove poison pill and other shark repellants and permit shareholders to call a special meeting and act by consent

Responding to an Activist Approach

- Response to Non-Public Communication.
    - No duty to discuss or negotiate (no outright rejection and try to learn as much as possible by just listening)
    - No duty to disclose unless leak comes from within
    - Response to any particular approach must be specially structured; team should confer to decide proper response
    - Keep board advised
    - No duty to respond, but failure to respond may have negative consequences
    - Be prepared for public disclosure by activist

- Response to Public Communication

  - No response other than "the board will consider"

  - Assemble team; inform directors

  - Call special board meeting to meet with team and consider the communication

  - Determine board's response and whether to meet with activist (failure to meet may be viewed negatively by institutional investors)

  - Avoid mixed messages

  - Gauge whether the best outcome is to agree upon board representation and/or strategic business change in order to avoid a proxy fight

  - Be prepared and willing to defend vigorously

  - The 2012 defeat by AOL of an activist short-slate proxy solicitation supported by ISS shows that investors can be persuaded to not blindly follow the recommendation of ISS. When presented with a well-articulated and compelling plan for the long-term success of a company, they are able to cut through the cacophony of short-sighted gains promised by activists touting short-term strategies. The AOL fight showed that when a company's management and directors work together to clearly present a compelling long-term strategy for value creation, investors will listen

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