January 2017

Dealing with Activist Hedge Funds and Other Activist Investors

Introduction

Significant developments during the past twelve months have prompted this new edition of our annual *Dealing with Activist Hedge Funds.*

Regardless of industry, size or performance, no company should consider itself immune from hedge fund activism. No company is too large, too popular, too new or too successful. Even companies that are respected industry leaders and have outperformed the market and their peers have come under fire.

There are more than 100 hedge funds currently engaged in frequent activism and over 300 others that have launched activism campaigns in recent years. While activist hedge funds have experienced a modest decline in assets managed in 2016, they are still estimated to have significantly more than $100 billion of assets under management, and remain an "asset class" that attracts investment from major traditional institutional investors.

Although a number of institutional investors are beginning to question whether hedge fund activism should be supported or resisted, the relationships between activists and more traditional investors in recent years have encouraged increasingly aggressive activist attacks. Several mutual funds and other institutional investors have on occasion also deployed the same kinds of tactics and campaigns as the dedicated activist funds. A number of funds have also sought to export American-style activism abroad, with companies throughout the world now facing classic activist attacks. There are, however, encouraging signs that major investors are increasingly concerned that hedge-fund activism is undermining long-term value, and that they are ready to support well-run companies and their long-term strategies against short-term activist attacks. For example, the January 23, 2017 corporate governance letter from Laurence Fink, Chairman and CEO of BlackRock, to the CEO's of the S&P 500 companies contains the following advice with respect to engagement:

> BlackRock engages with companies from the perspective of a long-term shareholder. Since many of our clients' holdings result from index-linked investments – which we cannot sell as long as those securities remain in an index – our clients are the definitive long-term investors. As a fiduciary acting on behalf of these clients, BlackRock takes corporate governance particularly seriously and engages with our voice, and with our vote, on matters that can influence the long-term value of firms. With the continued

growth of index investing, including the use of ETFs by active managers, advocacy and engagement have become even more important for protecting the long-term interests of investors.

Together with the International Business Council of the World Economic Forum, we have advanced a New Paradigm for an implicit corporate governance partnership between companies and investors that is gaining traction: *The New Paradigm, A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*. Until the pendulum fully shifts, however, companies will need to be prepared to address and respond to ongoing hedge-fund activism.

The major activist hedge funds are very experienced and sophisticated with professional analysts, traders, bankers and senior partners that rival the leading investment banks. They produce detailed analyses ("white papers") of a target's management, operations, capital structure and strategy designed to show that the changes they propose would result in an increase in share price in the near term. These white papers may also contain aggressive critiques of past decisions made by the target and any of the target's corporate governance practices that are not considered current "best practices". Many activist attacks are designed to facilitate a takeover or to force a sale of the target, either immediately or over time.

Prominent institutional investors and strategic acquirors have on occasion worked with activists both behind the scenes and by partnering in sponsoring an activist attack, such as CalSTRS with Relational in attacking Timken, Ontario Teachers' Pension Fund with Pershing Square in attacking Canadian Pacific and Valeant with Pershing Square in attempting a takeover of Allergan. Major investment banks, law firms, proxy solicitors and public relations advisors have represented activist hedge funds and actively solicited their business. These advisors to activist hedge funds have also aggressively sought to advise mutual funds and other investors on how to run their own activist campaigns.

Many activist attacks involve a network of activist investors ("wolf pack") that supports the lead activist hedge fund. They attempt to avoid the disclosure and other laws and regulations that would hinder or prevent the attack if they were deemed to be a "group" acting in concert. Sometimes at the fringe of the wolf pack are more traditional institutional investors, not actively joining in the attack, but letting the leader of the pack know that it can count on their support in a proxy fight.

Institutional investors own a majority of most public companies, and the outcome of a proxy contest at many of the larger public companies is often, as a practical matter, determined by the votes of the three major passive investors:

BlackRock, State Street and Vanguard. Credibility with major institutional investors, and the ability to persuade them to support companies' long-term strategies, both as a general matter and as a company-specific matter, is key to fending off an activist attack.

<u>The Attack Devices Used by Activists</u>

- aggressively criticizing a company's governance, management, business and strategy and presenting the activist's own recommendations and business plan;
- proposing a precatory proxy resolution for specific actions prescribed by the activist or the creation of a special committee of independent directors to undertake a strategic review for the purpose of "maximizing shareholder value";
- recruiting candidates with industry experience to serve on dissident slates, and conducting (or threatening to conduct) a proxy fight to get board representation at an annual or special meeting or through action by written consent (solicitation for a short slate is very often supported by ISS and, if supported, is often, though not always, successful, in whole or in part);
- orchestrating a "withhold the vote" campaign;
- seeking to force a sale by leaking or initiating rumors of an unsolicited approach, publicly calling for a sale, acting as an (unauthorized) intermediary with strategic acquirers and private equity funds, taking positions in both the target and the acquiror, making their own "stalking horse" bid or partnering with a hostile acquirer to build substantial stock positions in the target to facilitate a takeover;
- rallying institutional investors and sell-side research analysts to support the activist's arguments;
- using stock loans, options, derivatives and other devices to increase voting power beyond the activist's economic equity investment;
- using sophisticated public relations, social media and traditional media campaigns to advance the activist's arguments;
- investing in significant diligence and third-party consulting services to analyze the target's business;
- hiring private investigators to create dossiers on directors, management and key employees and otherwise conducting aggressive "diligence"; and
- litigation.

Current SEC rules do not prevent an activist from secretly accumulating a more than 5% position before being required to make public disclosure and do not prevent activists and institutional investors from privately communicating and cooperating.

Prevention of, or response to, an activist attack is an art, not a science. There is no substitute for preparation. The issues, tactics, team and approaches to an activist challenge will vary depending on the company, the industry, the activist and the substantive business and governance issues in play. To forestall an attack, a company should regularly review its business portfolio and strategy and its governance and executive compensation issues. In addition to a program of advance engagement with investors, it is essential to be able to mount a defense quickly and to be agile in responding to changing tactics. A well-managed corporation executing clearly articulated strategies can still prevail against an activist, even when the major proxy advisory firms support the activist. Given the risks and potential harm of a full-blown battle, in certain situations the best response to an activist approach may be to seek to negotiate with the activist and reach a settlement on acceptable terms, if such a settlement is feasible, even if the company believes it could win a proxy fight. However, when a negotiated resolution is not achievable on acceptable terms, whether because the activist's proposals are inimical to the company's business goals and strategy or because the activist is unwilling to be reasonable in its negotiation, the ability to wage an effective campaign will depend on advance preparation, proactive action, good judgment and effective engagement with shareholders. This outline provides a checklist of matters to be considered in putting a company in the best possible position to prevent, respond to or resolve a hedge fund activist attack.

Advance Preparation

Create Team to Deal with Hedge Fund Activism:

- A small group of key officers plus legal counsel, 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 and other investors 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 to 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 credibility the investor relations officer has with the institutional shareholders has been determinative in a number of proxy solicitations. Candid assessment of shareholder sentiment should be appropriately communicated to senior management, with periodic briefings provided to the board.
- Review capital return policy (dividends and buybacks), broader capital allocation framework, analyst and investor presentations and other financial public relations matters (including disclosed metrics and guidance).
- Monitor peer group, sell-side analysts, proxy advisors, active asset managers, and internet commentary and media reports for opinions or facts that will attract the attention of activists.
- Be consistent with the company's basic strategic message.
- Objectively assess input from shareholders and whether the company is receiving candid feedback. The company should make sure that major investors feel comfortable expressing their views to the company and believe that the company honestly wants to hear any concerns or thoughts they have.
- Proactively address reasons for any shortfall versus peer benchmarks. Anticipate key questions and challenges from analysts and activists, and be prepared with answers. Monitor peer activity and the changes peers are making to their businesses, as well as key industry trends.
- Build credibility with shareholders and analysts before activists surface.
- 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. Pay close attention to activist funds that commonly act together or with an institutional investor.
- Maintain regular contact with major institutional investors, including both portfolio managers and proxy voting/governance departments; CEO, CFO and independent director participation is very important. Consider engagement with proxy advisory firms.
- Major institutional investors, including BlackRock, Capitol, Fidelity, State Street, TIAA, T.Rowe Price and Vanguard, have established significant proxy departments that make decisions independent of ISS. 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 may be possible to defeat an activist attack supported by ISS by gaining the support of major institutional shareholders.

- Consider whether enhancements to company disclosures or changes to governance practices are appropriate in light of evolving shareholder expectations.
- Monitor third-party governance ratings and reports and seek to correct inaccuracies.
- Maintain up-to-date plans for contacts with media, regulatory agencies, political bodies and industry leaders and refresh relationships.
- Monitor investor conference call participants, one-on-one requests and transcript downloads.

Prepare the Board of Directors to Deal with the Activist Situation:

- Maintaining a unified board consensus on key strategic issues is essential to success in the face of an activist attack; 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.
- Keep the board informed of options and alternatives analyzed by management, and review with the board basic strategy, capital allocation 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 or business changes.
- Schedule periodic presentations by the legal counsel and the investment banker to familiarize directors with the current activist environment and the company's preparation.
- 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.
- Boardroom debates over business strategy, direction and other matters should be open and vigorous but kept within the boardroom.
- 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.
- Scrutiny of board composition is increasing, and boards should self-assess regularly. In a contested proxy solicitation, institutional investors may

particularly question the "independence" of directors who are older than 75 or who have served for more than 10 to 12 years, especially where the board has not recently appointed new directors, in addition to more broadly assessing director expertise and attributes. Meaningful director evaluation is now a key objective of institutional investors, and a corporation is well advised to have it and talk to investors about it. Regular board renewal and refreshment, and having longer-term board development and succession plans, can be important evidence of meaningful evaluation.

- A company should not wait until it is involved in a contested proxy solicitation to offer its key institutional shareholders the opportunity to meet with its independent directors. Many major institutional investors have recommended that companies offer scheduled meetings with some (or all) of a company's independent directors. A disciplined, thoughtful program for periodic meetings and other engagement initiatives is advisable. See *Succeeding in the New Paradigm for Corporate Governance*.

Monitor Trading, Volume and Other Indicia of Activity:

- Employ stock watch service and monitor Schedule 13F filings.
- Monitor Schedule 13D and Schedule 13G and Hart-Scott-Rodino Act filings.
- Monitor parallel trading and group activity (the activist "wolf pack").
- Monitor activity in options, derivatives, corporate debt and other non-equity securities.
- Monitor attendance at analyst conferences, requests for one-on-one sessions and other contacts from known activists.

The Activist White Paper:

The activist may approach a company with an extensive high-quality analysis of the company's business that supports the activist's recommendations (demands) for:

- Return of capital to shareholders through share repurchase or special dividend.
- Change in capital structure (leverage).
- Sale or spin-off of a division.
- Change in business strategy.
- Change in cost structures.
- Improvement of management performance (replace CEO).
- Change in executive compensation.

- Merger or sale of the company.
- Change in governance: add new directors designated by the activist, separate the positions of CEO and Chair, declassify the board, remove poison pill and other takeover defenses, permit shareholders to call a special meeting (or lower thresholds for same) and act by written consent.

Responding to an Activist Approach

Response to Non-Public Communication:

- Assemble team quickly and determine initial strategy. Response is an art, not a science.
- No duty to discuss or negotiate, but usually advisable to meet with the activist and discuss the activist's criticisms and proposals (company participants in any such meeting should prepare carefully with the company's activist response team); no outright rejection absent study, try to learn as much as possible by listening and keep in mind that it may be desirable to at some point negotiate with the activist and that developing a framework for private communication may avoid escalation.
- Generally no immediate duty to disclose; determine when disclosure may be required, or desirable.
- Response to any particular approach must be specially structured; team should confer to decide proper response. Consider whether the activist's claims or demands have merit and/or are consistent with the company's own pending or proposed initiatives.
- Keep board advised (in some cases it may be advisable to arrange for the activist to present its white paper to the board or a committee or subset of the directors).
- No duty to respond, but failure to respond may have negative consequences, and in most cases response is desirable.
- Be prepared for public disclosure by activist and have public response contingencies ready in the event of any disclosure.
- Be prepared for the activist to contact directors, shareholders, sell-side analysts, business partners, employees and key corporate constituencies. Make sure directors understand that any contacts should be referred to CEO or other designated officer.
- Assess whether there are sensible business actions that can be taken or accelerated to preempt or undercut the activist attack and the extent to which the activist may attempt to publicly claim credit for such actions.

- Consider whether early negotiations with the activist and settlement should be pursued.

Response to Public Communication:

- Initially, no response other than "the board will consider and welcomes input from its shareholders."
- 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. Even in public situations, consider pursuing disciplined engagement with the activist. Failure to meet may also be viewed negatively by institutional investors. Recognize that the activist may mischaracterize what occurs in meetings.
- Avoid mixed messages and preserve the credibility of the board and management.
- Continuously gauge whether the best outcome is to agree upon board representation and/or strategic business or other change in order to avoid (or resolve) a proxy fight.
- Be prepared and willing to defend vigorously.
- Engage with other shareholders, not only the activist, to take investor temperature, solicit feedback and assess whether actions may (should) be taken by the company to secure support (if an activist identifies a legitimate issue, the company may propose its own plan for resolving any shortcomings that is distinct from the activist's solutions).
- Appreciate that the public dialogue is often asymmetrical; activists may make personal attacks and use aggressive language, but the company should not respond in kind.
- Remain focused on the business; activist approaches can be very distracting, but continued strong performance, though not an absolute defense, is one of the best defenses. When business challenges inevitably arise, act in a manner that preserves and builds credibility with shareholders. Maintain the confidence and morale of employees, partners and constituencies.
- A significant number of major institutional investors are increasingly skeptical of activists and activist platforms even as they closely scrutinize targeted companies as well. Investors can be persuaded not to blindly follow the recommendations of ISS in support of a dissident's proxy solicitation. When presented with a well-articulated and compelling plan for the long-term success of a company,

investors are able to cut through the cacophony of short-sighted gains promised by activists touting short-term strategies. As a result, 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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