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Dealing with Activist Hedge Funds and Other Activist Investors

Introduction

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. Activists set new records in 2018, targeting the largest number of companies (nearly 300), deploying more capital and winning a greater number of board seats (161) than ever before.

Campaigns by the most well-known activist hedge funds are surging, and there are more than 100 hedge funds currently engaged in activism. Activist hedge funds 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, and will act independently of activists, the relationships between activists and more traditional investors in recent years have encouraged increasingly frequent and 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 hedge funds have also sought to export American-style activism abroad, with companies throughout the world now facing classic activist attacks. Many activist attacks continue to be designed to force a takeover, sale or breakup of the target, or a change in management, either immediately or over time.

Elliott Management was the most active and, in many cases, aggressive activist of 2018. The *Wall Street Journal* noted that Elliott publicly targeted 24 companies in 2018, with Carl Icahn and Starboard runners-up with nine public targets each. These numbers do not include the increasing number of non-disclosed activist situations against major companies. The *New Yorker* published a lengthy profile of Paul Singer and Elliott in August, “Paul Singer, Doomsday Investor,” noting “Singer has excelled in this field in part because of a canny ability to discern his opponents’ weaknesses and a seeming imperviousness to public disapproval.”

It has become increasingly evident that the activism-driven corporate world is relatively fragile and is proving to be unsustainable, particularly when viewed in the broader context of rapidly changing political and social norms and

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increasing divisiveness across many planes of the social contract. A number of initiatives have been underway to establish a modern corporate governance framework that is calibrated to the current environment. For our part, at the request of the World Economic Forum, we prepared a paper titled, [*The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*](#), which was issued in September 2016. We updated [*The New Paradigm*](#) and discussed it in our memo, [*Some Thoughts for Boards of Directors in 2019*](#).

In essence, *The New Paradigm* conceives of corporate governance as a collaboration among corporations, shareholders and other stakeholders working together to achieve long-term value and resist short-termism. While we have seen considerable interest in *The New Paradigm* and similar initiatives from major institutional investors and other key stakeholders (for example, the [Investor Stewardship Group](#)), until such a framework is widely adopted and in the absence of legislation, it is unlikely that there will be any significant decrease in activism. Accordingly, companies should regularly review and adjust their plans to avoid an activist attack and to successfully deal with an activist attack if one should occur. Effective engagement with major shareholders is the essential element of activist defense, and the support of major investors, including the largest index funds, cannot be taken for granted.

The Attack Devices Used by Activists

- 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 (including retired CEOs of major companies or even former executives of the target) 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 acquirer, 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 accumulate positions secretly or 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.
- Seeking to create divisions within the boardroom or between the board and management.
- Reaching a company’s retail shareholders with weekly mailings, telephonic outreach, local newspaper advertisements and user-friendly infographics.
- Hiring private investigators to create dossiers on directors, management and key employees and otherwise conducting aggressive “diligence.”
- 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 relationships and 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; the team should also use that familiarity to be alert to any contacts or interest shown by known activists.
- 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 while updating the strategy as circumstances warrant.
- 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, Capital, Fidelity, State Street, TIAA, T. Rowe Price, Vanguard and Wellington, 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, which may include 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 should 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 stay confidential and be kept within the boardroom.
- 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 lengthy tenures, especially where the board has not recently appointed new directors, in addition to more broadly assessing director expertise and attributes. Directors may also be criticized for "overboarding" or attendance issues. Meaningful director evaluation is now a key objective of institutional investors, and a corporation is well advised to undertake 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 in unusual circumstances even all) of a company's independent directors. A disciplined, thoughtful program for periodic meetings and other engagement initiatives is advisable. See [*Shareholder Engagement: 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, and in many cases high-quality, analysis of the company's business and strategy 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, including ESG.
- Change in cost structures.
- Improvement of management performance or replacement of management (e.g., 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 respond, but failure to respond may have negative consequences, and in most cases response is desirable.
- 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.
- 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 try 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 negotiations with the activist and settlement should be pursued and at what point in time.

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.
- If the activist includes a demand – *e.g.*, replace the Chair or CEO – that the board finds unacceptable or non-negotiable, it may be advisable to make the board’s position on that item clear earlier rather than later, even if there is willingness to consider and negotiate other aspects of the activist’s platform.
- Avoid mixed messages and preserve the credibility of the board and management.
- Continuously gauge whether the best outcome is to agree upon board change and/or strategic, business or other action in order to avoid (or resolve) a proxy fight.
- Be prepared and willing to defend vigorously.
- Recognize that a proxy fight will entail a meaningful time commitment from both management and directors, and work in advance to coordinate availability for key meetings with shareholders and proxy advisory firms.
- 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 strong business 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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