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Dealing with Activist Hedge Funds and Other Activist Investors

Introduction

Regardless of industry, size or performance, no company is too large, too popular, too new or too successful to consider itself immune from shareholder activism. Although poor stock price performance and operational and strategic missteps can increase vulnerability, even companies that are respected industry leaders and have outperformed the market and their peers have been and are being targeted by activists.

In addition to campaigns from a single activist, companies are susceptible to attacks from multiple activists at once, whether from a "wolf pack" of activist funds acting together or independent activists "swarming" the company at the same time. Activists are also increasingly prone to waging multi-year campaigns, for example at companies with classified boards of directors or at companies where their campaigns were only partially successful. Even companies that have effectively fended off activism may still find themselves targeted by the same or a different activist in subsequent years. These trends, and the increasing willingness of activists to approach a company not only in the lead-up to a company's nomination deadline and annual meeting proxy, but even shortly *after* the annual meeting date, contribute to a sense that there is no longer an "off-season" for activism.

While the largest and most established activists continue to dominate activism activity, smaller and emerging activists have become prevalent in recent years. In the current shareholder engagement climate, even a small, relatively unknown shareholder could get enough traction as an activist to warrant the attention of senior management and the board of directors. Extensive and real-time media coverage of activism, especially involving "household name" companies, offers essentially free publicity for emerging activist players to press their campaigns and try to build their reputations. Given activists' continued sophistication in avoiding early detection of share accumulations, companies may learn for the first time that an activist has taken a stake by reading it in a news story—along with the rest of the world.

There are typically only a handful of ideas that activists seek to push at companies: changes to board and management composition, increased return of capital, break-up or sale of the company (in whole or in part), and improved operations. M&A-related campaigns include pushing companies, publicly or privately, to run a sales process, partnering with a financial sponsor to buy a company

(or bid for a company, thereby putting it into play even if the activist bidder does not become the ultimate buyer), as well as agitating against announced transactions in an effort to increase the merger consideration. Activists have also increasingly called for changes in management, particularly at the CEO level, or — particularly where the activist does not have a viable replacement candidate — argued that a board has insufficiently prepared for CEO succession. Rather than pursuing a single thesis, some activists may launch campaigns with multiple ideas, including ones in the alternative. For example, an activist campaign might argue for improved operations under new management, or in the alternative, an exploration of strategic alternatives. This trend makes it more important than ever for boards to have a clear vision for the company's strategy so they can holistically refute such "kitchen-sink" campaigns.

Although asset managers and institutional investors will often act independently of activists, it is not uncommon for them to publicly support activist theses or even agitate behind the scenes for activist involvement. American-style activism also continues to be exported abroad, with companies throughout the world now facing classic activist attacks. The line between hedge fund activism and private equity continues to blur in some situations, with some activist funds becoming bidders themselves for all or part of a company, and a handful of private equity funds exploring activist-style investments in, and engagement with, public companies.

The universal proxy rules that have been in effect for the last few years do not seem to have improved activists' levels of success at the ballot box, as some originally theorized they would. However, the rules do seem to have increased the pace of settlements with activists. While there remain the occasional highly publicized proxy fights, including some that go all the way to a vote, the average length of time from the public launch of an activist campaign to settlement has decreased significantly over the past couple of years. To some degree, this may also be a function of the ability of activists to recruit more credible director candidates, increasing the likelihood that a company is able to resolve an activist situation by agreeing on a nominee whose addition to the board may be preferable to a full-scale fight. And where activists are unable or unwilling to recruit director candidates, "withhold" campaigns remain a tool for activists to be able to single out directors and exert pressure on a company. The form of resolving an activist campaign has also continued to evolve: in several instances, companies have chosen to forgo a formal written settlement agreement with an activist in favor of a more informal approach, which involves a press release announcing the agreed-upon governance or operational changes at the company and recognizing the role the activist played in leading to such changes.

Companies that continue to take shareholder activism preparedness seriously, including by conducting regular vulnerability assessments with the aid of

advisors, maintaining a strong pipeline of potential director candidates, and not losing sight of the board's core responsibilities, including effective oversight and succession planning, are better able to defend against or preempt activist theses and ensure a swifter resolution of activist situations.

This memo is based upon our experiences avoiding, defusing, resolving and prevailing in contested situations and proxy fights. We work with companies in "peacetime," "negotiation time," and "wartime" so that, if and when a situation arises, they are in the best possible position to respond with as minimal disruption to the business as possible. In supporting CEOs, chief legal officers/general counsels and boards of directors, we approach the legal issues involved in activism and activism defense within the larger framework of a company's strategic, business and financial goals.

Summarized below is an overview of some of the tactics and themes deployed by activists, followed by a listing of the elements of advance preparation and responsiveness to put a company in the best possible position to prevent, defend against or resolve an activist attack.

Tactics and Themes Deployed by Activists

- 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.

- Seeking to force a sale of all or part of the company by publicly calling for a sale or divestiture, leaking or initiating rumors of an unsolicited takeover approach, acting as an (unauthorized) intermediary with strategic acquirers or private equity funds, taking positions in both the target and the acquirer, making a "stalking-horse" bid for all or part of the company (with or without secured financing), partnering with a hostile acquirer to build substantial stock positions in the target to facilitate a takeover, or partnering with private equity funds.

- Orchestrating a "withhold the vote" campaign against the company's incumbent directors.

- Seeking to create divisions within the boardroom or between the board and management.

- Using stock loans, options, derivatives and other devices to accumulate positions secretly, and to announce (or leak to the media) surprisingly large, leveraged economic stakes.

- Criticizing a company's board composition, governance, management, business and strategy, and presenting the activist's own recommendations, projections and business plans, through a "white paper" or other public documents or statements.

- Asking the board to hold the CEO directly accountable for a company's underperformance, including advocating for CEO removal and suggesting successor candidates.

- Proposing a precatory proxy resolution for actions prescribed by the activist or the creation of a special committee of independent directors (sometimes including activist nominees) to undertake an operational or strategic review to "maximize shareholder value."

- Waging repeated campaigns at the same company, regardless of the outcome of the initial campaign, or joining with other activists to converge on the same company at the same time.

- Demanding an accelerated "Investor Day" at which the company would be pushed to disclose aggressive forward-looking projections, financial targets and actions involving its business and allocation of capital.

- Pairing economic arguments with governance or sustainability, climate or human capital-related proposals, in an effort to garner support from the company's broader stakeholders, including proxy advisory and governance teams within institutional investors.

- Leveraging proxy advisory firms and their recommendations to amplify the activist's influence.

- Communicating with and rallying institutional investors and sell-side research analysts to support and refine the activist's arguments.

- Using sophisticated public relations, social media and traditional media campaigns to advance the activist's arguments.

- Reaching a company's retail shareholders and employees through Internet forums and social media channels, weekly mailings, telephonic outreach, local newspaper advertisements and user-friendly infographics.

- Investing in significant diligence and third-party consulting services to analyze the target's strategy, business, operating margins and financial performance.

- Hiring private investigators to create dossiers on directors, management and key employees and otherwise conducting aggressive "diligence."

- Conducting extensive surveys of current and former employees, customers, suppliers and competitors.

- Initiating or threatening litigation, including demands for company books and records, sometimes concurrently with a proxy fight.

Prevention of, or response to, an activist attack is an art, not a science. There is no substitute for preparation. It is essential to be able to mount a defense quickly and to be agile in responding to changing tactics. The issues, tactics, team and approaches to an activist challenge will vary depending on the company, the management and board dynamics, the industry, the activist and the substantive business and governance issues in play.

To forestall an attack, a company should regularly review its business strategy and portfolio, how it is balancing growth and profitability, margin priorities and pressures, its stakeholder relationships, engagement strategies and feedback, its board composition and corporate governance and its executive compensation. The company should also play offense in anticipation of activism and in resolving activism, finding opportunities, as appropriate, to explain the company's strategies and preempt potential activist attacks on the company's direction. A program of ongoing engagement with investors is a critical component in cultivating credibility with investors and developing their understanding of the company's business and strategy. A well-managed corporation executing clearly articulated, credible strategies can prevail against an activist by making its case to the rest of its shareholders.

Many investors increasingly expect companies to seek to engage constructively with activists. Given the risks, cost and potential harm of a full-blown proxy 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 making unreasonable demands, the ability to wage an effective campaign in response to the activist will depend on advance preparation, strong alignment between the board and management, proactive action, good judgment and effective relationships with shareholders.

Advance Preparation

Create Team to Deal with Activism:

- The core response team should be comprised of the CEO and the other key officers and outside legal counsel, financial advisor(s), a public relations firm and a proxy soliciting firm. More than a half-century of experience in dealing with activism of all types has shown that the interpersonal relationships among the members of the team play a major part in the outcome of an attack. Identifying the response team on a clear day will help engender trust and facilitate cohesive and swift action on a cloudy day.

- Designating a management point person, such as the CFO or the CLO/GC, is useful to help ensure a rapid response and minimize distractions, so that the CEO and operational management can continue to focus on running the business in the context of an activist attack.

- Continuing contact and periodic meetings or calls with the team are important. Many companies schedule a short quarterly call with the internal and external team as a regular checkpoint for updates and information sharing.

- A periodic fire drill with the team may also be helpful to maintain a state of preparedness; the team should be familiar with the hedge funds and other investors that have made activist approaches with a particular focus on those that have approached other companies in the same industry and the tactics each fund has used. The team should use that familiarity to be alert to any contacts or interest shown by known activists.

- The team should be immediately updated and assembled when an activist reaches out to the company through formal or informal channels. While board members need not attend working team fire drill sessions, it is also helpful to periodically update the board on the company's activism preparedness and the activism landscape in the company's industry.

Monitor Trading, Volume and Other Indicia of Activity:

- Employ a sophisticated 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.

- Monitor investor conference call participants, one-on-one requests and transcript downloads.

- Monitor company website traffic for unusual activity, including visits by known activists or their advisors or media outlets.

Shareholder Relations:

- Articulate, update and reinforce the company's strategic and operational priorities, progress and achievements.

- Articulate, update and share the company's position on corporate purpose and material stakeholder issues in appropriate forums. Although stakeholder divisions on certain social issues may require walking a narrow path on these issues, whether a company is able to skillfully balance competing stakeholder interests remains an important concern for large institutional investors.

- Review broader capital allocation framework (including reinvestment in the business and inorganic as well as organic growth strategies), capital return policy (dividends and buybacks), analyst and investor presentations and other financial public relations matters (including disclosed metrics, key performance indicators (KPIs) 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. These sources may also provide advance warning of theses that an activist may be promoting or testing.

- 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, including reasons why peer comparisons may be inapposite. 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 and strong relationships with shareholders and analysts before activists surface. The investor relations team is critical in assessing exposure to

an activist attack and in a proxy solicitation campaign. In many companies, the CFO is also critical to the investor relationships, and the chief legal officer/general counsel or her/his designee may have crucial relationships and be one of the officers who spends time with the major index funds and the stewardship/proxy voting teams at the actively managed funds. Other members of the legal or human resources teams may also be a part of the conversation with investors and stewardship teams, particularly with respect to executive compensation questions. The credibility that these officers have with the institutional shareholders has been determinative in a number of proxy contests. Candid assessment of shareholder sentiment should be appropriately communicated to senior management, with periodic briefings provided to the board.

- Maintain regular contact with major institutional investors, including both portfolio managers and proxy voting/governance departments; CEO, CFO and, for some investors, independent director, participation is important, and the role of the CLO/GC should also be considered, especially with the index funds and stewardship teams. Consider engagement with proxy advisory firms.

- Major institutional investors have established significant proxy departments that make decisions independently of ISS and Glass Lewis, and the portfolio managers at actively managed funds covering the company often have clear "override" authority on key votes. 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 defeat an activist attack supported by proxy advisors by gaining the support of major institutional shareholders.

- Regular review by counsel expert in activism and takeover defense of the company's structural defense profile, including as reflected in its charter, bylaws and other governing documents and policies, with an eye towards ensuring effective practices and avoiding reflexively capitulating to "one size fits all" approaches that may prove unduly empowering of hostile actors, involve premature changes in light of company-specific circumstances or otherwise not be in the best interests of the company.

- Consider whether enhancements to company disclosures or updates to governance and oversight practices are appropriate in light of evolving shareholder expectations.

- Monitor third-party governance and sustainability ratings and reports and seek to correct inaccuracies.

- Monitor annual meeting vote results, including "say on pay" votes, and develop plans for dealing with problematic vote outcomes through shareholder engagement, while taking a measured approach that prioritizes the best interests of the company and does not over-react or "over-index" on voting percentages.

- Deal with shareholder proposals (such as those submitted under Rule 14a-8) effectively, recognizing that engagement and negotiated withdrawals of such proposals and creative approaches to the board's recommendation and proxy statement regarding such matters may be superior to reflexive "always oppose" or "always seek to exclude" approaches.

- Monitor changes in hedge fund and institutional investor holdings on a regular basis, and understand the shareholder base, including, to the extent practicable, relationships among holders. Pay close attention to activist funds that commonly act together or with an institutional investor, and to investors who are known to support or even enlist activist funds or deploy activist campaign tactics.

- Maintain up-to-date plans for contacts with media, regulatory agencies, political bodies, industry leaders and other stakeholders, and refresh relationships with these groups.

- Be aware that the shareholder engagement landscape is dynamic, and changes to SEC rules and investor policies may alter the state of play for companies and their investors.

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

- Maintaining board unity 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 an unnecessary special committee be formed. If the board already contains directors previously appointed through a settlement with an activist, or otherwise elected through a proxy fight, endeavor to maintain solidarity with such directors in the face of a new activist threat or threat from the same activist who nominated such director.

- Keep the board informed of strategic options and alternatives analyzed by management, and review with the board key strategic and operational undertakings and metrics, including capital allocation, cash flow, portfolio mix, revenue and margin growth, taking into account possible arguments for spinoffs, share buybacks, increased leverage, special dividends, cost-cutting initiatives, a

sale of all or part of the company or other structural or strategic business changes or reforms.

- Schedule periodic presentations by legal counsel and financial advisors to familiarize directors with the current activist environment and the company's preparation, potential vulnerabilities and external team.

- Directors should guard against subversion of the responsibilities of the full board by activists or related parties, and directors should avoid being drawn into conversations with third parties and should refer all approaches by activists to the CEO or other designated officer.

- Boardroom debates over business strategy, direction and other matters should be open and vigorous but stay confidential and be kept within the boardroom. Directors and management should take care not to share the "mood" or "temperature" of the boardroom with outside parties. Directors should have in place a strong confidentiality policy covering board matters and deliberations.

- Scrutiny of board composition is increasing, and boards should self-assess regularly. While tenure and experience are important, in a contested proxy solicitation, some institutional investors may 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. Directors may also be criticized for "overboarding," which continues to be an area of investor scrutiny as board responsibilities continue to expand, or for attendance issues.

- Meaningful and recurring board evaluation is a key objective of institutional investors, and a corporation is well advised to undertake it and talk to investors about it, including through the use of an independent third party such as legal counsel. 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 involving one or more of a company's independent directors. Of course, access to independent directors should be considered in a disciplined and thoughtful manner, recognizing that independent directors will not be able to meet with every significant shareholder.

Responding to an Activist Approach

Response to Non-Public Communication:

- Assemble the team quickly and determine initial strategy. Response is an art, not a science.

- Although there is no legal duty to meet or negotiate with an activist, failure to respond may have negative consequences, and in most cases, it is advisable to engage with the activist and discuss the activist's perspectives and proposals. Company participants in any such meeting should prepare carefully with the company's activist response team and there should be at least two company participants in any such meeting. General guidelines for such meetings include: no outright rejection or acceptance of the activist's ideas or proposals absent further analysis; try to learn as much as possible by listening; be circumspect and avoid giving the activist any "sound bites" that could be used against the company in a public fight; and keep in mind that it may be desirable at some point to negotiate with the activist and that developing a framework for private communication may avoid escalation. If the activist nevertheless chooses to escalate, this engagement will allow the company to demonstrate to its other shareholders its responsiveness, open-mindedness and attempts to be constructive.

- Generally, there is no immediate duty to disclose conversations with an activist; determine when disclosure may be required or desirable, recognizing that the activist may choose to go public at any time (affirmatively or via media leak). Be prepared for public disclosure by the activist and have immediate public response contingencies ready in the event of any disclosure.

- Keep the board advised; in some cases, it may be advisable to arrange for the activist to present its views or proposals to the board or a committee or subset of the directors.

- 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 the CEO or other designated officer and any engagement with an activist should be coordinated centrally through the company.

Response to Public Communication:

- In the event an activist goes public, it is usually best to keep the initial response to "the board will consider and welcomes input from its shareholders."

However, the response team should determine whether there is anything in the activist's initial public disclosure that warrants a more substantive response immediately.

- Assemble the team quickly; inform directors.

- Determine the timing for the board to meet with the response team and consider the communication.

- Determine the board's response and whether to meet with the activist. Even in public situations, consider pursuing disciplined engagement with the activist. Failure to meet may be viewed negatively by institutional investors. There should be at least two company representatives at any meeting or call with the activist, recognizing that the activist may try to mischaracterize what occurs in meetings.

- 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. Similarly, unexpected poor performance can undermine a company's defense. When and if business challenges arise, act in a manner that preserves and builds credibility with shareholders.

- Maintain the confidence and morale of employees, partners and other stakeholders.

- Avoid mixed messages and preserve the credibility of the board and management.

- Appreciate that the public dialogue is often asymmetrical; activists may make personal attacks and use aggressive language or advance unrealistic financial projections, but the company's response should be disciplined and fact-based and should not respond to personal attacks in kind.

Resolving an Activist Situation:

- Engage with other shareholders, not only the activist, to assess investor sentiment, solicit feedback and discern whether actions may (and should) be taken by the company to secure support. If an activist identifies a legitimate issue, then the company may propose its own plan for resolving any shortcomings that is distinct from the activist's proposed solutions or that co-opts any sensible concepts.

- If the activist makes 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.

- Continuously gauge whether the best outcome is to agree upon board representation and/or strategic, business or other action in order to avoid (or resolve) a proxy fight. Weigh the potential significant disruption, cost, and time commitment for the board and management of pursuing a proxy fight and a realistic assessment of the likely outcome, versus the risk and potential negative consequences to the company from accepting the activist's board candidates or business suggestions.

- Recognize that a proxy fight will entail a meaningful time commitment from a subset of both management and directors, and work in advance to coordinate availability for key meetings with shareholders and proxy advisory firms.

- A significant number of major institutional investors are increasingly skeptical of activists and activist platforms even as they closely scrutinize targeted companies. Investors can be persuaded not to follow the recommendations of proxy advisors such as ISS or Glass Lewis in support of a dissident's proxy solicitation. When presented with a well-articulated and compelling corporate purpose and plan for the long-term, sustainable success of a company, investors are often able to cut through the cacophony of short-sighted gains promised by activists touting short-term strategies and advancing disingenuous attacks. As a result, when a company's management and directors work together to present a compelling long-term strategy for value creation, and have built credibility with their investors, the investors should listen and respond favorably.

- Consider whether some of the activist's claims, proposals or demands are consistent with the company's own pending or proposed initiatives or otherwise have merit. Assess whether there are sensible disclosures, commitments or business actions that can be made, 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 disclosures, commitments or actions.

- In light of the multi-year campaigns activists are willing to wage, do not lose credibility in making unrealistic commitments to win a proxy fight in year one. Overpromising may put the company in a worse position the following year.

- Understand the activist also has reputational and financial costs associated with pursuing a fight.

- Consider whether negotiations with the activist should be pursued or explored and, if so, at what point in time. Settlement leverage may change favorably or unfavorably with the passage of time and proximity to the annual meeting.

- Remember that settling with one activist does not mean there is not another potential activist who might pursue a campaign, and time any settlement for maximal deterrent effect for other activists (*e.g.*, after the nomination deadline has passed).

- Be prepared and willing to defend vigorously, if a reasonable settlement is not possible.

Martin Lipton
Steven A. Rosenblum
Karessa L. Cain
Elina Tetelbaum
Loren Braswell
Anna Dimitrijević