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Dealing with Activist Hedge Funds and Other Activist Investors

Introduction

Activism has remained robust over the past year, following a post-pandemic rebound. As we have previously noted, regardless of industry, size or performance, no company is too large, too popular, too new or too successful to consider itself immune from 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. Companies of various sizes have faced and remain 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. And activists are not averse to waging multi-year campaigns; even companies that have successfully fended off activism may still find themselves targeted by the same or a different activist in successive years.

Amid ongoing macroeconomic uncertainty, activist theses focused on cost-cutting, capital allocation and management succession have taken a front seat next to M&A theses, particularly at companies facing cash flow headwinds and slowing revenue and margin growth. While the largest and most established activists continue to dominate activism activity, smaller and emerging activists have deployed less predictable (and often public) strategies to make their mark. Even a relatively unknown activist with a small ownership position can garner enough attention from the media to put the target company, regardless of its size, in an unwanted limelight.

In addition to traditional hedge fund activism—which is primarily focused on driving economic returns—recent years have also seen issue-oriented activism focused on addressing sustainability, DEI, human capital and other social and governance concerns. While issue-oriented activism has most frequently manifested itself in Rule 14a-8 shareholder proposals, the recent proxy season saw for the first time an issue-oriented activist launch a proxy contest to address concerns on freedom of affiliation and labor rights. Companies have faced pressure from issue-oriented activists on all sides voicing their views on a growing range of platforms, including social media. The recent backlash against ESG does not appear to have slowed the momentum of issue-oriented activism, although investor support for environmental and social shareholder proposals has continued to decline.

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Although asset managers and institutional investors will often act independently of activists, it is not uncommon for them to publicly vocalize support for activist theses. American-style activism also continues to be exported abroad, with companies throughout the world now facing frequent classic activist attacks. The line between hedge fund activism and private equity continues to blur, 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, which have now been in effect for two proxy seasons, do not appear to have significantly affected activist tactics or improved activists' levels of success at the ballot box, as some had predicted. Despite the ability, under universal proxy, for the proxy advisory firms and investors to mix and match support for activist nominees and company nominees, companies have still received broad support from ISS, Glass Lewis and the large index funds in a number of proxy fights. Indeed, the number of seats won by activists in proxy contests that went to a vote declined during the past proxy season. The vast majority of board seats achieved by activists continue to be via settlements with activists, which in the last proxy season have been entered into by companies at higher rates and in shorter time periods from when the activist surfaces.

Companies that continue to take shareholder activism preparedness seriously, including by conducting regular vulnerability assessments with the aid of advisors and maintaining a strong pipeline of potential director candidates, are better able to defend against or preempt activist theses and ensure a swifter resolution of activist situations. How activist campaigns are settled have also continued to evolve. In several instances, companies have chosen to forgo a formal written settlement agreement with an activist in favor of simply publicly announcing certain board, operational, management, M&A or other strategic changes with recognition of the role the activist played in leading to the changes.

For many years, we have updated this memo based on recent developments, evolving trends and our experiences avoiding, defusing, resolving and prevailing in contested situations and proxy fights to provide the most cogent and current advice to our clients and friends. Summarized below is a snapshot of some of the tactics and themes deployed by activists, followed by a checklist of matters to be considered in putting a company in the best possible position to prevent, respond to or resolve an activist attack.

### The Attack Devices Used by Activists

- 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.
- 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.
- 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.
- Aggressively criticizing a company’s board composition, governance, management, business and strategy, sustainability and diversity, equity and inclusion (DEI) strategies, and presenting the activist’s own recommendations 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 the portfolio 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 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/or ESG impact and 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.

After robust debate and longstanding efforts, including by us, to address loopholes in the beneficial ownership reporting rules, the SEC released modernized rules in fall 2023. Among other changes, the new rules shorten the time period from when an activist accumulates shares representing 5% or greater of a voting class of shares in a company to when it must publicly disclose this

ownership from 10 calendar days to 5 business days. The SEC also provided guidance regarding when an investor's use of certain cash-settled derivative securities may confer beneficial ownership and thereby require disclosure. While the new rules could have gone further to fully alert investors to potential changes in corporate control (and in some cases notably did not go as far as the original proposed rulemaking), they are an important step forward for market transparency and help address some of the deficiencies of the prior rules, particularly in settings where activists have M&A plans or proposals.

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 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. In addition to a program of ongoing 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, credible strategies can prevail against an activist by making its case to the rest of its shareholders. A well-advised corporation should also play offense in anticipation of activism and in resolving activism.

Many investors increasingly expect companies to seek to engage constructively with activists. Given the risks, cost 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 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 comprise the CEO and the other key officers and outside legal counsel, financial advisor(s), public relations firm and 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.

- Designating a management point person, such as the CFO or the CLO/GC, is useful to help ensure 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.
- A periodic fire drill with the team is helpful 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. Team should be immediately updated and assembled when an activist reaches out to the company through formal or informal channels.

#### 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.

#### 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 these 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 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. 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 that spend time with the major index funds and the stewardship/proxy voting teams at the actively managed funds. Chief sustainability officers are increasingly common, particularly at larger companies, and can also be a part of the conversation with investors and stewardship teams. 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 classic “always oppose” or “always seek to exclude” approaches.

- Monitor changes in hedge fund and institutional investor holdings on a regular basis; 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 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.

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 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.
- 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, especially in the era of the universal proxy card, and boards should self-assess regularly. While tenure and experience are important, 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. Directors may also be criticized for “overboarding,” which has become a growing area of investor scrutiny as board responsibilities continue to expand, or for attendance issues.
- Meaningful and recurring board evaluation is now 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. A disciplined, thoughtful program for periodic meetings and other engagement initiatives is advisable.

### 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 failure to respond may have negative consequences, and in most cases it is advisable to meet 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 absent further analysis of idea; 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; 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, the company will be able to demonstrate to its other shareholders its responsiveness, open-mindedness and attempts to be constructive.

- Generally no immediate duty to disclose conversations with 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.
- 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.
- 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.

#### 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, consider whether there is anything in the activist's initial public disclosure that warrants a more substantive response immediately.
- Assemble team quickly; inform directors.
- Determine 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. Recognize that the activist may mischaracterize what occurs in meetings. There should be at least two company representatives at any meeting or call with the activist.
- 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.
- 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.
- 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, if a reasonable settlement is not possible.
- 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 assess investor sentiment, solicit feedback and assess whether actions may (and 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 or co-opts any sensible concepts).
- 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.

- 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 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 will listen and respond favorably.

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