Dealing With Activist Hedge Funds

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Thursday, November 6, 2014

Tags: Boards of Directors, Hedge funds, Shareholder activism
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Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton and **Sabastian V. Niles**. Recent work from the Program on Corporate Governance about hedge fund activism includes: **The Long-Term Effects of Hedge Fund Activism** by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum **here**); **The Myth that Insulating Boards Serves Long-Term Value** by Lucian Bebchuk (discussed on the Forum **here**); **The Law and Economics of Blockholder Disclosure** by Lucian Bebchuk and Robert J. Jackson Jr. (discussed on the Forum **here**); and **Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy** by Lucian Bebchuk, Alon Brav, Robert J. Jackson Jr., and Wei Jiang.

This year has seen a continuance of the high and increasing level of activist campaigns experienced during the last 14 years, from 27 in 2000 to nearly 250 to date in 2014, in addition to numerous undisclosed behind-the-scenes situations. Today, regardless of industry, no company can consider itself immune from potential activism. Indeed, no company is too large, too popular or too successful, and even companies that are respected industry leaders and have outperformed peers can come under fire. Among the major companies that have been targeted are, Amgen, Apple, Microsoft, Sony, Hess, P&G, eBay, Transocean, ITW, DuPont, and PepsiCo. There are more than 100 hedge funds that have engaged in activism. Activist hedge funds have approximately $200 billion of assets under management. They have become an "asset class" that continues to attract investment from major traditional institutional investors. The additional capital and new partnerships between activists and institutional investors have encouraged increasingly aggressive activist attacks.

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 quickly boost shareholder value. These white papers may also contain aggressive critiques of past decisions made by the target. Some activist attacks are designed to facilitate a takeover or to force a sale of the target, such as the failed Icahn attack on Clorox. Prominent institutional investors and strategic acquirors have been working 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 partnering with Pershing Square to force a takeover of Allergan.

Many major activist attacks involve a network of activist investors ("wolf pack") who support the lead activist hedge fund, but attempt to avoid the disclosure and other laws and regulations that would hinder or prevent the attack if they were, or were deemed to be, a group that is acting in concert. Not infrequently, at the fringe of the wolf pack are some of the leading institutional investors, not actively joining in the attack, but letting the leader of the pack know that it can count on them in a proxy fight. Major investment banks, law firms, proxy solicitors, and public relations advisors are now representing activist hedge funds and are eagerly soliciting their business.

Among the attack devices used by activists are:

- aggressively criticizing a company's announced initiatives and strategic actions 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";

- conducting a proxy fight to get board representation at an annual or special meeting or through action by written consent (note that solicitation for a short slate is very often supported by ISS and, if supported, is often successful, in whole or in part, and ISS is increasingly showing support for "control" slates);
- 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, making their own "stalking horse" bid or partnering with a hostile acquirer to build secret, substantial stock positions in the target to facilitate a takeover;
- rallying institutional investors and sell-side research analysts to support the activist;
- 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;
- hiring private investigators to establish dossiers on directors, management and key employees and otherwise conducting aggressive "diligence"; and
- litigating to obtain board records and materials and to block transactions.

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. In addition to a program of advance engagement with investors, it is essential to be able to mount a defense quickly and to be flexible in responding to changing tactics. To forestall an attack, a company should continuously review its business portfolio and strategy and its governance and executive compensation issues sensibly and in light of its particular needs and circumstances. Companies must regularly adjust strategies and defenses to meet changing market conditions, business dynamics and legal developments.

This outline provides a checklist of matters to be considered in putting a company in the best possible position to prevent or respond to hedge fund activism.

Advance Preparation

Create Team to Deal with Hedge Fund Activism:

- A small group (2-5) of key officers plus lawyer, investment banker, proxy soliciting firm, and public relations firm
- Continuing contact and periodic meetings of the team are important
- A periodic fire drill with the team is the best way to maintain a state of preparedness; the team should be familiar with the hedge funds that have made activist approaches generally and be particularly focused on those that have approached other companies in the same industry and the tactics each fund has used
- Periodic updates of the company's board of directors

Shareholder Relations:

- The investor relations officer is critical in assessing exposure to an activist attack and in a proxy solicitation. The regard in which the investor relations officer is held by the institutional shareholders has been determinative in a number of proxy solicitations. Candid investor relations assessment of shareholder sentiment should be appropriately communicated to senior management, with periodic briefings provided to the board
- Review 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 like ISS, activist institutions like CalSTRs and TIAA-CREF, Internet commentary and media reports for opinions or facts that will attract the attention of attackers
- Be consistent with the company's basic strategic message
- Objectively assess input from shareholders—is the company receiving candid and direct feedback
- Proactively address reasons for any shortfall versus peer company benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers; build credibility with shareholders and analysts before activists surface and attempt to "educate" the sell-side
- Monitor changes in hedge fund and institutional shareholder holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders, paying close attention to activist funds that commonly act together or with an institutional investor
- Maintain regular, close contact with major institutional investors; CEO, CFO and independent director participation is very important; regularly engage with portfolio managers as well as proxy-voting departments
- Monitor ISS, GL, CII, TIAA-CREF corporate governance policies; activists try to "piggy-back" on process issues to bolster the argument for management or business changes
- Monitor third-party governance ratings and reports for inaccuracies and/or flawed characterization
- Major institutional investors, including BlackRock, Fidelity, State Street and Vanguard have established significant proxy departments that make decisions independent of ISS and GL and warrant careful attention. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision-makers and point-persons are and how best to reach them. It is possible to mount a strong defense against an activist attack that is supported by ISS and GL and gain the support of the major institutional shareholders
- Maintain up-to-date plans for contacts with media, regulatory agencies and political bodies and refresh relationships
- Monitor conference call participants, one-on-one requests and transcript downloads
- Continue regular temperature taking calls pre- and post-earnings and conferences and exercise caution and oversight with respect to large format or "group" investor meetings

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 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 changes
- Schedule periodic presentations by the lawyer and the investment banker to familiarize directors with the current activist environment
- Directors must guard against subversion of the responsibilities of the full board by the activists or related parties and should refer all approaches to the CEO
- 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
- A company should not wait until it is involved in a contested proxy solicitation to have its institutional shareholders meet its independent directors. A disciplined, thoughtful program for periodic meetings is advisable
- Scrutiny of board composition is increasing, and boards should self-assess regularly. In a contested proxy solicitation, institutional investors may particularly question the "independence" of directors who are older than 75 or who have served for more than 10 to 15 years

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 and derivatives, as well as corporate debt and other non-equity securities

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 a special dividend
- Sale or the spin-off of a division
- Change in business strategy
- Improvement of management performance (replace CEO)
- Change in executive compensation
- Change in cost structures
- 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 shark repellants, and permit shareholders to call a special meeting (or lower thresholds for same) and act by written consent in lieu of a meeting

The white paper is used by the activist in private meetings with shareholders, sell-side analysts and the media and is ultimately designed for public consumption

Responding to an Activist Approach

Response to Non-Public Communication:

- Assemble team and determine initial strategy. Response is an art, not a science
- No duty to discuss or negotiate (no outright rejection, 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 and non-public engagement may avoid escalation)
- No duty to disclose unless leak comes from within
- Response to any particular approach must be specially structured; team should confer to decide proper response
- Keep board advised (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
- Be prepared for public disclosure by activist
- Be prepared for the activist to try to engage directly with shareholders, sell-side analysts, business partners, employees and key corporate constituencies

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. Failure to meet may be viewed negatively by institutional investors. Meeting may result in activist using the meeting to mischaracterize the company’s position

- Avoid mixed messages and preserve the credibility of the board and management
- Gauge whether the best outcome is to agree upon board representation and/or strategic business or other change in order to avoid a proxy fight
- Be prepared and willing to defend vigorously
- Appreciate that the public dialogue is often asymmetrical; while activists can, often without consequence, make personal attacks and use aggressive language, the company cannot respond in this manner
- Remain focused on the business; activist approaches can be all-consuming, but continued strong performance of the business, though not an absolute defense, is one of the best defenses. When business challenges inevitably arise, acting in a manner that preserves and builds credibility with shareholders and rest of investment community is of paramount importance. Maintain the confidence and morale of employees, business partners and key constituencies
- The 2012 defeat by AOL of an activist short-slate proxy solicitation supported by ISS shows that investors can be persuaded to not blindly follow the recommendation of ISS. When presented with a well-articulated and compelling plan for the long-term success of a company, they are able to cut through the cacophony of short-sighted gains promised by activists touting short-term strategies. The AOL fight showed that when a company's management and directors work together to clearly present a compelling long-term strategy for value creation, investors will listen
- The recent amendments, and then full withdrawal, by Carl Icahn of his attempt to force Apple into leveraging its balance sheet and paying out $150 billion to its shareholders, showed that investors can be convinced not to support an activist attack that is not in the long-term best interests of the company's shareholders (Icahn later restated his support for continued buybacks). In this connection, it is noteworthy that on March 21, 2014, Larry Fink, Chairman and CEO of BlackRock, wrote to the CEOs of the S&P 500:

> Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. Corporate leaders can play their part by persuasively communicating their company's long-term strategy for growth. They must set the stage to attract the patient capital they seek: explaining to investors what drives real value, how and when far-sighted investments will deliver returns, and, perhaps most importantly, what metrics shareholders should use to assess their management team's success over time.
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> It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies. Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks. We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns.
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> We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments—in innovation and product enhancements, capital and plant equipment, employee development, and internal controls and technology—that will sustain growth.
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> BlackRock's mission is to earn the trust of our clients by helping them meet their long-term investment goals. We see this mission as indistinguishable from also aiming to be a trusted, responsible shareholders with a longer term horizon. Much progress has been made on company-shareholder engagement and we will continue to play our part as a provider of patient capital in ensuring robust dialogue. We ask that you help us, and other shareholders, to understand the investments you are making to deliver the sustainable, long-term returns on which our clients depend and in which we seek to support you.