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# **TAKEOVER RESPONSE CHECKLIST**

## **DEALING WITH ACTIVIST HEDGE FUNDS**

## **SHAREHOLDER ENGAGEMENT: SUCCEEDING IN THE NEW CORPORATE GOVERNANCE PARADIGM**

2018

## **Takeover Response Checklist**

Notwithstanding the constant criticism from academics, activists and other so called governance experts, takeover preparedness has never been more important. Failure to prepare for a takeover or demands from an activist exposes potential targets to pressure tactics and reduces the target's ability to control its own destiny. This outline provides a checklist of matters to be considered in putting a company in the best possible position to respond to a takeover bid, pressure from an activist, a proxy fight or a consent solicitation or to negotiate a merger. This is a general comprehensive checklist; not all the matters in this outline are appropriate for any one company.

Takeover defense is an art, not a science. It is essential to be able to adopt new defenses quickly and to be flexible in responding to changing takeover tactics. Whatever the state of the law may be and however it may change, in order to achieve the best result in a takeover situation a company must have effective defenses and keep them up to date. In addition to regular portfolio reviews by management, an annual board of directors "fire drill," with participation of the company's investment banker and legal counsel, is important for dealing with an attack, if one comes. Of equal importance, a company must maintain excellent investor relations, with the CEO and CFO having regular contact with the key portfolio managers and analysts, and director(s) being prepared to participate directly in engagement with key shareholders in appropriate cases.

### **Advance Preparation**

#### 1. Create Team to Deal with Takeovers

- Small group (2-5) of key officers plus legal counsel, investment banker, proxy soliciting firm, and public relations firm
- Ensure ability to convene special meeting of board within 24 to 48 hours
- Continuing contact and periodic meetings are important
- A periodic fire drill is the best way to maintain a state of preparedness
- Periodic updates of board
- Warlist of contacts updated regularly

#### 2. Prepare Instructions for Dealing with:

- Press
- Message boards, blogs and other real time sources
- Stock Exchange
- Directors
- Employees and unions
- Customers/suppliers/banks
- Institutional investors and analysts
- Public officials and government contacts

3. Review Structural Defenses, Consider Implementing Additional Defenses If Necessary

a. Bear in mind:

- In many cases a structural defense is possible only if there has been careful advance preparation by the Company and its investment banker and legal counsel (see 7 and 8 below)
- While staggered election of the board of directors and supermajority merger votes or other shark repellents have had limited success in defeating most any-and-all cash tender offers, they may be effective in deterring other types of takeovers (including proxy fights) and are worth retaining, if the Company has them currently
- Structural defenses and supermajority voting requirements need to be reviewed in light of negative reactions from institutional investors and impact on corporate governance ratings and institutional voting services' recommendations

b. Charter and bylaw provisions

- Staggered board
- Ability of stockholders to act by written consent
- Advance notice provisions for nominations and business at stockholder meetings
- Ability of stockholders to call a special meeting
- Ability of stockholders to remove directors without cause
- Ability of stockholders to expand size of board and fill vacancies
- Supermajority voting provisions (fair price, etc.)
- Authorization of sufficient common and blank-check preferred stock
- Director qualification requirements
- Cumulative voting
- Preemptive rights
- Constituencies
- Majority voting (resignation with acceptance in business judgment of the board)

c. "Poison Pill"

- Permits board to "just say no," Airgas case
- Purported antidotes ineffective
- Consider treatment of derivatives
- Institutional pressure to submit pills to a shareholder vote
- Dealing with shareholder proposals and director withhold vote recommendations for pill renewals
- Avoid poison pill policies, governance principles and by-laws as they limit flexibility
- "Dead Hand" provision (not valid in Delaware)

- d. Structure of loan agreements and indentures
  - e. Change of control triggers in joint venture agreements and other material contracts
  - f. ESOP arrangements; plans to increase employee ownership
    - Dept. of Labor and SEC fiduciary considerations
  - g. Customer protection plans
  - h. Options under state takeover laws
    - Control share
    - Business combination
    - Fair price
    - Pill validation
    - Constituencies
    - Long-term prospects vs. short-term price
    - Disclosure
4. Additional Advance Preparation
- Review of the business portfolio and strategy: dividend policy, leverage, share repurchase, divestitures and spinoffs
  - Advance preparation of earnings projections and liquidation values for evaluation of takeover bid and alternative transactions
  - Amendments to stock options, employment agreements, executive incentive plans and severance arrangements (“golden parachutes”)
  - Amendments to employee stock plans with respect to voting and accepting a tender offer
  - Protection of overfunded pension plans
  - White knight/white squire arrangements
  - Review availability of regulatory defenses, including CFIUS
5. Shareholder Relations
- Maintain excellent investor relations
  - Review dividend policy, analyst presentations and other financial public relations
  - Prepare fiduciary holders with respect to takeover tactics designed to panic them
  - Review trustees for various company plans and determine if changes required
  - Monitor changes in institutional holdings on a regular basis
  - Plan for contacts with institutional investors (including maintenance of an up-to-date list of holdings and contacts) and analysts and with media, regulatory agencies and political bodies
  - Remain informed about activist hedge funds and activist institutional investors and about corporate governance and proxy issues
  - Role of arbitrageurs and hedge funds

6. Prepare Board of Directors to Deal with Takeovers

- Maintaining a unified board consensus on key strategic issues is essential to success
- Schedule periodic presentations by legal counsel and investment bankers to familiarize directors with the takeover scene and the law and with their advisors
- Company may have policy of continuing as an independent entity
- Company may have policy of not engaging in takeover discussions
- Directors must guard against subversion by raider and should refer all approaches to the CEO
- Avoid being put in play; psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a takeover target
- Review corporate governance guidelines and reconstitution of key committees
- Discuss the importance of independent directors meeting with ISS and major shareholders during a proxy solicitation or a takeover

7. Preparation by Investment Banker

- Maintain up to date due diligence file and analysis of off-balance sheet values
- Consider defensive acquisitions, recapitalization, spin-off and tracking stock alternatives
- Perform semiannual review
- Know your raiders — advance preparation for dealing with a specific potential raider may be the key to a successful defense
- Communication of material developments and regular contact is important

8. Preparation by Legal Counsel

- Review structural defenses such as poison pill
- Review charter and bylaws; make sure they reflect “state of the art”
- Review business to determine products and markets for antitrust analysis of a raider
- Understand regulatory agency approvals for change of control
- Consider impact of change of control on business
- Consider disclosures that might cause a potential raider to look elsewhere
- Consider defensive acquisitions, recapitalization, spin-off and tracking stock alternatives
- Consider amendments to stock options, executive compensation and incentive arrangements and severance arrangements, and protection of pension plans
- Consider ESOPs and other programs to increase employee ownership
- Regular communication and periodic board presentations are important

9. Prepare CEO to Deal with Takeover Approaches

- The CEO should be the sole spokesperson for the company on independence, merger and takeover
- Handling casual passes (bearhugs)
- Handling offers
- Communications with officers and board of directors
- Company may have policy of not commenting upon takeover discussions and rumors

## Responding to Bidder Activity

### 1. Types of Activity

- Accumulation in the market
- Casual pass/nonpublic bear hug
- Public offer/public bear hug
- Tender offer
- Proxy contest/consent solicitation
- Demand by activist for board representation

### 2. Responses to Accumulation in the Market

- Monitor trading, hedge fund accumulation and 13(f) filings
- Maintain contact with specialist
- Monitor analyst reports and react appropriately
- Look for bidder Schedule 13D and Hart-Scott-Rodino filings
- Board has duty to prevent transfer of control without premium
- Monitor/combat disruption of executives, personnel, customers, suppliers, etc.
- Monitor uncertainty in the market; change in shareholder profile
- Consider responses to accumulation:
  - Poison pill can be structured so that flip-in takes effect at 10% to 15% threshold (N.Y. corporations 20%)
  - Engage with activist
  - Consider board seat/strategy change versus a creditable proxy fight
  - Litigation
  - Standstill agreement

### 3. Effect of Hart-Scott-Rodino Antitrust Act and Antitrust Enforcement Policies

- a. Hart-Scott should prevent dawn raids on big companies but under Hart-Scott a raider can buy up to \$84.4M (this figure is updated annually by the FTC), and there is a 10% passive investment exception that has been misused by raiders
- b. A raider cannot complete its purchases until the requisite waiting period has expired:

Cash tender offer/bankruptcy:	15 calendar days
All other situations:	30 calendar days
If second request issued:	30 calendar days (10 calendar days in cash tender offer/bankruptcy) after substantial compliance

- c. Antitrust enforcement policies should be reviewed regularly, particularly when there is a change in administration or personnel
  - d. Foreign filings are increasingly important
4. Responses to Casual Passes/Non-Public Bear Hugs
- No duty to discuss or negotiate
  - 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; meeting with potential bidder or activist may be best strategy
  - Keep the board advised; participation by independent directors may be critical
5. Response to Public Offers/Public Bear Hugs
- No response other than “will call you back”
  - Call war list and assemble team; inform directors
  - Call special board meeting to consider bidder proposal
  - No press release or statement other than “stop-look-and-listen”
  - Consider trading halt (NYSE limits halt to short period)
  - Determine whether to meet with raider (refusal to meet may be a negative factor in litigation)
  - In a tender offer, Schedule 14D-9 must be filed within 10 business days and must disclose:
    - Board’s position (favor; oppose; neutral) and reasoning
    - Negotiations
    - Banker’s opinion (optional)
6. Special Meeting of Board to Consider Offer
- a. Board should be informed of the following:
    - Board has no duty to accept or negotiate a takeover offer
    - A premium over market is not necessarily a fair price; a fair price is not necessarily an adequate price
    - The “just say no” response was approved in the Time Warner case and reaffirmed in the Paramount, Unitrin and Airgas cases and continues to be good strategy and good law
    - Where outside directors are a majority, there is no need for a special committee to deal with takeovers nor do the independent directors need separate legal counsel
    - Board must act in good faith and on a reasonable basis; business judgment rule applies to takeovers (modified rule applies in Delaware, where defensive action must be proportional to threat)
    - Partial offers present fairness issues which in and of themselves may warrant rejection and strong defensive action
  - b. Presentation:
    - Management -- budgets, financial position, real values (off-balance sheet values), new products, general outlook, timing

- Investment banker -- opinion as to fairness or adequacy, assessment of bidder, quality of bidder's financing, state of the market and the economy, comparable acquisition premiums, timing
  - Legal counsel -- terms and conditions of proposal, legality of takeover (antitrust, compliance with SEC disclosure requirements, regulatory approval of change of control, etc.), bidder's history, reasonable basis for board action
- c. Board may consider:
- inadequacy of the bid
  - nature and timing of the offer
  - questions of illegality
  - impact on constituencies other than shareholders
  - risk of nonconsummation
  - qualities of the securities being offered (if bid is not all cash)
  - basic shareholder interests at stake, including the past actions of the bidder
  - strategic alternatives

### **Strategic Alternatives**

#### 1. Remaining Independent

- a. "Just say no" defense is available as a legal matter, but may not be available in practice
- Refuse to redeem poison pill
  - Wage proxy fight to keep control of board (if board is staggered, bidder cannot get control and redeem pill without two annual meetings)
- b. Consider expanded disclosures about Company's standalone business plans and forecasts
- c. Consider white squire arrangements
- d. Consider actions which decrease the Company's attractiveness as a takeover target
- New acquisitions (e.g., to create antitrust problems for bidder or increase size of transaction for bidder)
  - Asset sales or spin-off
  - Share repurchases/self-tender
  - Issue targeted stock
  - Recapitalization

#### 2. Merger of Equals

- Early, proactive efforts to pursue mergers of equals are necessary, as they are generally impossible to implement as a takeover defense.
- MOEs offer an alternative to an outright sale in which two organizations of similar size can combine their organizations in an effort to provide shareholders with greater long-term values.

- Management and other “social” issues are the key to an MOE’s success or failure; these issues can be particularly challenging to address when combining companies with different corporate cultures.
- A variety of contractual and legal structures are available to implement agreements on social issues, although basic trust and common objectives are key.
- Careful planning is critical to avoid placing one or both parties “in play” prior to the announcement of the transaction and to anticipate possible shareholder concerns.
- Lock-up protections are appropriate to protect the transaction once it is announced. The record must show the MOE is not intended to be a sale of either company.
- MOEs can be “fair” even though higher short-term value could be obtained in an outright sale of the Company.

### 3. Joint Ventures and Strategic Alliances

- Strategic alliances and joint ventures have significant control ramifications.
- These transactions raise complex tax, accounting and sale of control considerations, which must be carefully analyzed against the backdrop of alternate strategic options.
- These transactions often present all the complexities of a full acquisition with the added complexity of shared governance and the need to construct an inherently imperfect exit mechanism.
- Short-term objectives need to be carefully balanced against potential longer-term ramifications.

### 4. Sale of the Company

#### a. Options:

- Locate white knight
- LBO/MBO
- Auction
- Sell significant subsidiary or division (“crown jewel” or other)
- Negotiate with bidder

b. Bear in mind: if Revlon duties are triggered, board will not be able to reverse course

c. Exploration by CEO of possible sale or merger (including strategic merger of equals) should only be undertaken after consultation with expert advisers

d. Form of confidentiality/standstill agreement used may have important ramifications

## **Dealing with Activist Hedge Funds**

### **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, and attacks on successful companies have increased.

Recent Bloomberg and Fortune articles of Elliott Management (“The World’s Most Feared Investor—Why the World’s CEOs Fear Paul Singer” and “Whatever It Takes to Win—How Paul Singer’s Hedge Fund Always Wins”) highlight what can be expected in an aggressive activist attack. In addition to the well-known dedicated activist hedge funds, their offshoots and progeny, there are more than 100 hedge funds currently engaged in frequent activism and over 300 others that have launched activism campaigns in recent years. While activist hedge funds experienced a modest decline in managed assets in 2016, they were resurgent in 2017 and 2018, substantial new capital has been raised by activist hedge funds and several activists have created special purpose funds for investment in a single target. The activist fund is an established “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 generally resisted, the relationships between activists and more traditional investors in recent years have encouraged increasingly aggressive activist attacks. Several mutual funds and other institutional investors have on occasion also deployed the same kinds of tactics and campaigns as the dedicated activist funds. A number of funds have also sought to export American-style activism abroad, with companies throughout the world now facing classic activist attacks. While an activist attack on a large successful company to force acceptance of a financial engineering strategy has generally failed, e.g., GM’s resounding defeat of Greenlight Capital’s attempt to get shareholder approval of converting common stock into two classes and to replace incumbent directors, there has been an increase in attacks to obtain a change in a company’s CEO and an increase in attacks designed to force the target into a sale, merger or private equity deal. Trian Partners’ ultimately achieving a board seat for founder Nelson Peltz at Proctor & Gamble following a bruising public campaign has become a frequently discussed cautionary tale.

There are, however, encouraging signs that major investors are increasingly concerned that hedge-fund activism overall is undermining long-term value, and that they are ready to support well-run companies and their long-term strategies against short-term activist attacks. For example, the January 2018 [BlackRock letter](#) from Laurence Fink, Chairman and CEO of BlackRock, to S&P500 company CEOs contains the following advice with respect to engagement:

Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

Together with the International Business Council of the World Economic Forum, in September 2016 we advanced a new paradigm for an implicit corporate governance partnership between companies and investors that is gaining traction: [\*The New Paradigm, A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth\*](#). The New Paradigm is the basis for a continuing effort launched this year by the World Economic Forum to gain endorsement by corporations and investors of long-term investment and sustainability principles. This was followed by the publication by a group of major investors of [\*The Principles of the Investor Stewardship Group\*](#) that, like The New Paradigm, is designed to promote long-term investment. We have subsequently synthesized the New Paradigm, the Investor Stewardship Group principles and a number of other recent guidelines promoting governance, engagement and stewardship into a single overview. See, [\*A Synthesized Paradigm for Corporate Governance, Investor Stewardship and Engagement\*](#). In addition, there is growing academic concern raising questions about the validity of the economic theories and empirical studies that have been relied on to justify short-termism and attacks by activist hedge funds. See, [\*Corporate Governance\*](#).

**Unless and until the pendulum fully shifts, however, companies will need to be prepared to address and respond to ongoing hedge-fund activism.**

The major activist hedge funds are very experienced and sophisticated with professional analysts, traders, bankers and senior partners that rival the leading investment banks. They produce detailed analyses (“white papers”) of a target’s management, operations, capital structure and strategy claiming to show that the changes they propose would result in an increase in share price in the near term. These white papers may also contain aggressive critiques of past decisions made by the target and any of the target’s corporate governance practices that are not considered current “best practices”. Increasingly, these white papers may be intensely personal in nature and involve direct attacks against individual members of management or the board of directors, in addition to critiques of the company. Many activist attacks are designed to facilitate a takeover or to force a sale or breakup of the target, either immediately or over time.

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

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

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

votes of the three major “passive” investors: BlackRock, State Street and Vanguard – their votes cannot be taken for granted. Credibility with major institutional investors, and the ability to persuade them to support companies’ long-term strategies, both as a general matter and as a company-specific matter, is key to fending off an activist attack.

### **The Attack Devices Used by Activists**

In recent years, activists have utilized a wide range of strategies as part of their attacks. These have included:

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

- Seeking to drive a wedge between management and the board, or to undermine unanimity of the board, by launching targeted attacks focused on specific members of management or specific directors (e.g., longer-serving “legacy” directors versus relatively new directors); and
- Litigation.

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

Prevention of, or response to, an activist attack is an art, not a science. There is no substitute for preparation. The issues, tactics, team and approaches to an activist challenge will vary depending on the company, the industry, the activist and the substantive business and governance issues in play. To forestall an attack, a company should regularly review its business portfolio and strategy and its governance and executive compensation issues. In addition to a program of advance engagement with investors, it is essential to be able to mount a defense quickly and to be agile in responding to changing tactics. A well-managed corporation executing clearly articulated strategies can still prevail against an activist, even when the major proxy advisory firms support the activist.

Given the risks and potential harm of a full-blown battle, in certain situations the best response to an activist approach may be to seek to negotiate with the activist and reach a settlement on acceptable terms, if such a settlement is feasible, even if the company believes it could win a proxy fight. However, when a negotiated resolution is not achievable on acceptable terms, whether because the activist’s proposals are inimical to the company’s business goals and strategy or because the activist is unwilling to be reasonable in its negotiation, the ability to wage an effective campaign will depend on advance preparation, proactive action, good judgment and effective engagement with shareholders. This outline provides a checklist of matters to be considered in putting a company in the best possible position to prevent, respond to or resolve a hedge fund activist attack.

### **Advance Preparation**

#### **Create Team to Deal with Hedge Fund Activism:**

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

#### **Shareholder Relations:**

- Build credibility with shareholders and analysts before activists surface.

- Maintain regular contact with major institutional investors, including both portfolio managers and proxy voting/governance departments; Chairman, 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/Nuveen, T. Rowe Price and Vanguard, have established significant proxy departments that make decisions independent of ISS. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision-makers and point-persons are and how best to reach them. It may be possible to defeat an activist attack supported by ISS by gaining the support of major institutional shareholders.
- 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, asset managers, and internet commentary and media reports for opinions or facts that will attract the attention of activists.
- Be consistent with the company's basic strategic message.
- Objectively assess input from shareholders and whether the company is receiving candid feedback. The company should make sure that major investors feel comfortable expressing their views to the company and believe that the company honestly wants to hear any concerns or thoughts they have.
- Consider whether a third-party survey of shareholders would be useful in understanding what investors really think about the company.
- 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.
- 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.
- Consider whether enhancements to company disclosures or changes to governance practices are appropriate in light of evolving shareholder expectations.
- Monitor third-party governance ratings and reports and seek to correct inaccuracies.

- Maintain up-to-date plans for contacts with media, regulatory agencies, political bodies and industry leaders and refresh relationships.
- Monitor investor conference call participants, one-on-one requests and transcript downloads.

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

- Maintaining a unified board consensus on key strategic issues is essential to success in the face of an activist attack; in large measure, an attack by an activist hedge fund is an attempt to drive a wedge between the board and management by raising doubts about strategy and management performance and to create divisions on the board by advocating that a special committee be formed.
- Keep the board informed of options and alternatives analyzed by management, and review with the board basic strategy, capital allocation and the portfolio of businesses in light of possible arguments for spinoffs, share buybacks, increased leverage, special dividends, sale of the company or other structural or business changes.
- Schedule periodic presentations by the legal counsel and the investment banker to familiarize directors with the current activist environment and the company's preparation.
- Directors must guard against subversion of the responsibilities of the full board by the activists or related parties and should refer all approaches to the Chairman and CEO.
- Boardroom debates over business strategy, direction and other matters should be open and vigorous but kept within the boardroom.
- Avoid being put in play; recognize that psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a target.
- Scrutiny of board composition is increasing, and boards should self-assess regularly. In a contested proxy solicitation, institutional investors may particularly question the "independence" of directors who are older than 75 or who have served for more than 10 to 12 years, especially where the board has not recently appointed new directors, in addition to more broadly assessing director expertise and attributes. 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 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 a 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 activist hedge funds and other institutional investors with activist tendencies.

### **The Activist White Paper:**

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

- Return of capital to shareholders through share repurchase or special dividend.
- Change in capital structure (financial engineering).
- Sale or spin-off of a division.
- Change in business strategy.
- Change in cost structures.
- Improvement of management performance or replacement of the 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.
- ESG/Sustainability: Sustainability-focused themes remain rare in an activist attack but may occur in certain cases.

### **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 legal duty to discuss or negotiate, but usually advisable to meet with the activist and discuss the activist's ideas, criticisms and proposals (company participants in any such meeting should prepare carefully with the company's activist response team before the meeting); 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 legal duty to disclose (absent a specific disclosure trigger); 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 contact or attempt 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 Chairman, CEO or other designated officer.
- Assess whether there are sensible business actions that can be taken or accelerated to preempt or undercut the activist attack and the extent to which the activist may attempt to publicly claim credit for such actions.
- Consider whether early negotiations with the activist and settlement should be pursued.

**Response to Public Disclosure of Idea or Proposal by Activist:**

- 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 will likely be viewed negatively by institutional investors. Recognize that the activist may mischaracterize what occurs in meetings.
- Avoid mixed messages and preserve the credibility of the board and management.
- Continuously gauge whether the best outcome is to agree upon board change and/or strategic business or other actions 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 institutions and other shareholders, not only the activist, to take investor temperature, solicit feedback and assess whether actions may (should) be taken by the company to secure support (if an activist identifies a legitimate issue, the company may propose its own plan for resolving any shortcomings that is distinct from the activist's solutions).
- Appreciate that the public dialogue is often asymmetrical; activists may make personal attacks and use aggressive language, but the company should not respond in kind.
- Remain focused on the business; activist approaches can be very distracting, but continued strong performance, though not an absolute defense, is one of the best defenses. When business challenges inevitably arise, act in a manner that preserves and builds credibility with shareholders. Maintain the confidence and morale of employees, partners and constituencies.
- A significant number of major institutional investors are increasingly skeptical of activists and activist platforms even as they closely scrutinize targeted companies as well. Investors can be persuaded not to blindly follow the recommendations of ISS in support of a dissident's proxy solicitation. When presented with a well-articulated and compelling plan for the long-term success of a company, investors are able to cut through the cacophony of short-sighted gains promised by activists touting short-term strategies. As a result, when a company's management and directors work together to clearly present a compelling long-term strategy for value creation, investors will listen.

## **Shareholder Engagement: Succeeding in the New Paradigm for Corporate Governance**

The accelerated interest in sustainability, ESG, corporate social responsibility and investment for long-term growth and value creation (the new paradigm) as most cogently exemplified by Value Act's newly formed Spring Fund focusing on promoting environmental and social goals of the companies in which it invests; by the promotion by the World Economic Forum of *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*; by the creation of the Investors' Stewardship Group and its issuance of its principles for stewardship which embrace ESG and long-term investment; and, finally, by the policy positions of the three largest index fund managers, BlackRock, State Street and Vanguard as to what they expect in the way of governance and engagement, especially the January 12, 2018 letter from Larry Fink, BlackRock's CEO, to the CEOs of the companies in which BlackRock invests in which "corporate purpose" is stressed, prompts us to update our January 2017 memo on engagement with investors,

The [BlackRock letter](#) states:

Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

Then, most importantly, the letter sets out the type of engagement between corporations and their shareholders that BlackRock expects in order to secure its support against activist pressure. While the whole letter needs to be carefully considered in developing investor relations engagement practices, the following is of special note,

In order to make engagement with shareholders as productive as possible, companies must be able to describe their strategy for long-term growth. I want to reiterate our request, outlined in past letters, that you publicly articulate your company's strategic framework for long-term value creation and explicitly affirm that it has been reviewed by your board of directors. This demonstrates to investors that your board is engaged with the strategic direction of the company. When we meet with directors, we also expect them to describe the board process for overseeing your strategy.

The statement of long-term strategy is essential to understanding a company's actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company's strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also

understand the societal impact of your business as well as the ways that broad, structural trends – from slow wage growth to rising automation to climate change – affect your potential for growth.

While the BlackRock letter is a major step in rejecting activism and short-termism and is a practical guide as to investor relations, it stops short of a critical step in assuring corporations that their efforts are bearing fruit—it does not commit BlackRock to publicly state its support for a corporation under attack by an activist seeking to impose financial engineering or other short-term action before the corporation has to endure a proxy fight. This type of early concrete support would be a major factor in supporting sustainability and long-term investment. That being said, it does not in anyway diminish the importance of understanding and appropriately reacting to the letter and the views of BlackRock and other investors.

In designing its engagement program and practices, each company should make its own independent decision as to content, persons, venues and intensity of its communications and what adjustments, if any, to its strategy and operations may be appropriate to meet the expectations of investors who have embraced the new paradigm.

### **What to Communicate**

**Lead with the Purpose and the Strategy.** In the new paradigm, the company's purpose and long-term strategy, its implementation and the company's progress in achieving it take center stage. Check-the-box governance fades into the background. Define the company and its vision, explain key drivers of strategy and business outcomes and articulate how a portfolio of businesses and assets fit together and are reviewed. Discuss key risks and mitigation methods and share how the company evaluates whether the strategy remains viable as the business environment, competitive landscape and regulatory dynamic change. Discuss how a business model has transformed, and if the company is in the midst of a strategic transformation or a well-conceived turnaround plan that requires time to execute, explain it. The BlackRock letter advises:

Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that that will help them achieve their goals?

**Confirm Board Involvement in the Strategy.** The company should explicitly describe how the board has actively reviewed long-term plans and that it is committed to doing so regularly. Proactively share with these investors how directors are integrated into strategic planning, exercise robust oversight and test and challenge both strategy and implementation. In the new paradigm, be clear and direct about the board's role in guiding, debating and overseeing strategic choices.

**Make the Case for Long-Term Investments, Reinvesting in the Business for Growth and Pursuing R&D and Innovation.** The company should clearly explain how such investments are reviewed and articulate why and how they matter to long-term growth and value

creation. For investments that will take time to bear fruit, acknowledge that and explain their importance, timing and progress.

**Describe Capital Allocation Priorities.** This also includes discussing the board's process for reviewing and approving capital allocation policies. Where return of capital is a pillar of the company's value creation framework, demonstrate thoughtfulness about the timing, pacing and quantum of buybacks and/or dividends and an awareness of relative tradeoffs. If maintaining an investment-grade or fortress balance sheet is a priority, clarify why.

**Explain Why the Right Mix of Directors Is in the Boardroom.** Present the diverse skills, expertise and attributes of the board as a whole and of individual members and link those to the company's needs and risks. Be transparent about director recruitment processes that address future company and board needs. Disclose the policy for ensuring that board composition and practices evolve with the needs of the company, including views on balance, tenure, retaining institutional knowledge, board refreshment and presence or absence of age or term limits. Carefully explain procedures for increasing the diversity of the board and for ensuring that directors possess the skills required to direct the course of the company. Discuss director orientation, tutorials and retreats for in-depth review of key issues. Show that board, committee and director evaluations are substantive exercises that inform board roles, succession planning and refreshment objectives.

**Address Sustainability, Citizenship and ESG/CSR.** The company should integrate relevant sustainability and ESG matters into strategic and operational planning and communicate these subjects effectively. Sharing sustainability information, corporate responsibility initiatives and progress publicly on the company's website and bringing them to these investors' attention are significant actions in the new paradigm.

**Articulate the Link Between Compensation Design and Corporate Strategy and Risk Management.** Describe how compensation practices encourage and reward long-term growth, promote implementation of the strategy and achievement of business goals and protect shareholder value.

**Discuss How Board Practices and Board Culture Support Independent Oversight.** Clearly articulate the actual practices and responsibilities of the lead independent director or non-executive chair, independent directors, committee chairs and the board as a whole in providing effective oversight, understanding shareholder perspectives, evaluating CEO performance and organizing themselves to ensure priorities are met.

**How to Deal With an Activist.** A paragraph in the BlackRock letter sums it up well:

Where activists do offer valuable ideas – which is more often than some detractors suggest – we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed.

## How to Communicate

**Periodic “Letters” to Investors.** Periodic “letters” to shareholders on behalf of the management and/or board focusing on the issues deemed important for satisfaction of the new paradigm are valuable. Letters from management can articulate management’s vision and plans for the future, explain what the company is trying to achieve and discuss how it plans to win in the market. Letters from the board can convey board-level priorities and involvement. Depending on the circumstances, statements or letters may be separate, jointly signed by the CEO and the lead independent director or non-executive chair, come from particular committees as to matters within their ambit or be from the full board.

**Investor Days.** The company should use “Investor Days” to articulate a long-term perspective on company prospects and opportunities and provide “deep dives” into strategy, performance and capital allocation. Challenges should also be candidly addressed and responsive initiatives outlined. Deciding which long-term metrics, goals and targets should be shared is an area in active evolution. All of the company’s major long-term investors, including “passive” investors and index funds, should be extended an invitation. Key materials from a completed Investor Day can also be separately circulated to investors. The company may also invite directors to attend. In certain cases, it may be useful for a director to participate in an Investor Day to validate and communicate board involvement and priorities.

**Quarterly Communications.** Quarterly earnings rituals remain, for now, a fact of life in the U.S. Nevertheless, the company can place quarterly results in the context of long-term strategy and objectives, discuss progress towards larger goals and articulate higher priorities, all while eschewing quarterly guidance.

**Proxy Statements, Annual Reports, Other Filings and the Company’s Online Presence.** Proxy statements, annual reports/10-Ks, SEC filings, presentations and voluntary disclosures provide communication opportunities. For example, the customary proxy section entitled “The Board’s Role in Risk Oversight” will ultimately evolve into section(s) covering “Board Oversight of Strategy and Risk.” The company should present information online in readily accessible, user-friendly and well-organized formats.

**Investor Engagement.** Disciplined, direct and periodic two-way dialogue with institutional investors is advisable, supported by written communications and tailored presentations. Opening channels of communication in advance of a crisis or activist challenge is extremely important. Communicate engagement procedures and activity. Prepare for director-level interactions with major shareholders and know when and how to involve directors – proactively or upon appropriate request – without encroaching upon management effectiveness. Do not hesitate to reach out to investors, even during proxy season, if there is a matter of importance to discuss. Coordinate internal outreach across the different categories of shareholders and have a superstar corporate governance executive and a superstar investor relations executive. A number of the major investors are increasing substantially their stewardship teams that meet with companies.

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