Harvard Law School Forum on Corporate Governance and Financial Regulation

Dealing with Activist Hedge Funds

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Tuesday, June 2, 2015

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. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here) and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here).

Today, regardless of industry, no company can consider itself immune from hedge fund activism. Indeed, no company is too large, too popular or too successful, and even companies that are respected industry leaders and have outperformed the market and peers have come under fire. Among the major companies that have been targeted are Amgen, Apple, Microsoft, Sony, General Motors, Qualcomm, Hess, P&G, eBay, Transocean, ITW, DuPont, and PepsiCo. There are more than 100 hedge funds that have engaged in activism. Activist hedge funds are estimated to have over $200 billion of assets under management, and have become an "asset class" that continues to attract investment from major traditional institutional investors. The additional capital and relationships between activists and institutional investors encourages 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 and any of the target's corporate governance practices that are not current "best practices." Some activist attacks are designed to facilitate a takeover or to force a sale of the target. 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") which supports the lead activist hedge fund, but attempts 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. The outcome of a proxy contest at most 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. Major investment banks, law firms, proxy solicitors, and public relations advisors are now representing activist hedge funds and eagerly soliciting their business.

Among the attack devices used by activists are:

a. aggressively criticizing a company's announced initiatives and strategy and presenting the activist's own recommendations and business plan;
b. 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";
c. conducting 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 successful, in whole or in part);
d. orchestrating a "withhold the vote" campaign;
e. 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;
f. rallying institutional investors and sell-side research analysts to support the activist's arguments;
g. using stock loans, options, derivatives and other devices to increase voting power beyond the activist's economic equity investment;
h. using sophisticated public relations, social media and traditional media campaigns to advance the activist's arguments;
i. hiring private investigators to establish dossiers on directors, management and key employees and otherwise conducting aggressive "diligence"; and
j. litigation.

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. 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 flexible in responding to changing tactics.

DuPont's 2015 defeat of Trian Partners' proxy fight to replace four DuPont directors is an important reminder that a well-managed corporation executing clearly articulated strategies can still prevail against an activist, even when the major proxy advisory services support the activist.

This post 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 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 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.

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 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, activist institutions, 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.
- 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 business.
- Build credibility with shareholders and analysts before activists surface.
- Monitor changes in hedge fund and institutional shareholder holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders, paying close attention to activist funds that commonly act together or with an institutional investor.
- Maintain regular contact with major institutional investors and understand their policies; CEO, CFO and independent director participation is very important; regularly engage with both portfolio managers and proxy voting/governance departments.
- Monitor third-party governance ratings and reports for inaccuracies and flawed characterization.
- Major institutional investors, including BlackRock, Fidelity, State Street and Vanguard have established significant proxy departments that make decisions independent of ISS 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 supported by ISS and gain the support of the major institutional shareholders.

- Maintain up-to-date plans for contacts with media, regulatory agencies, political bodies and industry leaders and refresh relationships.
- Monitor conference call participants, one-on-one requests and transcript downloads.
- Continue temperature taking calls pre- and post-earnings releases and investor conferences.

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 or business changes.
- Schedule periodic presentations by the legal counsel 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 key institutional shareholders meet 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 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, in addition to more broadly assessing director expertise and attributes. Meaningful director evaluation is now a key objective of institutional investors, and a corporation is well advised to have it and talk to investors about it. Regular board renewal and refreshment can be important evidence of meaningful evaluation.

Monitor Trading, Volume and Other Indicia of Activity:

- Employ stock watch service and monitor Schedule 13F filings
- Monitor Schedule 13D and Schedule 13G and Hart-Scott-Rodino Act filings
- Monitor parallel trading and group activity (the activist “wolf pack”)
- Monitor activity in options, derivatives, corporate debt and other non-equity securities

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.
- Change in capital structure (leverage).
- Sale or spin-off of a division.
- Change in business strategy.
- Change in cost structures.
- Improvement of management performance (replace CEO).
- Change in executive compensation.
- Merger or sale of the company.
- Change in governance: add new directors designated by the activist, separate the positions of CEO and Chair, declassify the board, remove poison pill and other shark repellants, permit shareholders to call a special meeting (or lower thresholds for same) and act by written consent.

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, but usually advisable to meet with the activist and discuss the activist's criticisms and proposals (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).
- Basically no immediate duty to disclose; determine when disclosure may be required, or desirable.
- Response to any particular approach must be specially structured; team should confer to decide proper response.
- 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 contact directors, 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. Even in public situations, consider pursuing disciplined engagement with the activist. Failure to meet may also be viewed negatively by institutional investors. Recognize that the activist may mischaracterize what occurs in meetings.
- Avoid mixed messages and preserve the credibility of the board and management.
- Continuously 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; activists can make personal attacks and use aggressive language, but the company is limited in responding similarly.
- Remain focused on the business; activist approaches can be all-consuming, 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.
- The 2015 defeat by DuPont (discussed on the Forum here) of Trian Partners’ short-slate proxy solicitations 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 DuPont 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.