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Dealing with Activist Hedge Funds and Other Activist Investors

Introduction

The SEC rule requiring a universal proxy card in director election proxy fights becomes effective today. The resurgence of activism is already in progress, and the universal proxy card may significantly facilitate some proxy contests in which an activist is seeking to elect one or more directors to a company's board to replace incumbent(s). It will also affect proxy contest strategies, tactical considerations and the behavior of proxy advisory firms assessing competing director slates. As stated by ISS in its report on the universal proxy card:

The indisputable fact about the universal proxy card (UPC) is that it is a far superior way for shareholders to exercise their voting franchise than the two-card system that has dominated proxy contests for decades. But like the kid that receives the hot new toy at Christmas, only to become frustrated by its complex instructions, proxy advisors and investors will have to carefully navigate the first few UPC contests. Although UPC contests will increase the workflow of institutional investors, many funds have ramped up teams to evaluate these situations in recent years, so they are likely well prepared for this shift.

As we have previously noted, regardless of industry, size, performance or "newness" to the public markets, no company should consider itself immune from activism. No company is too large, too new or too successful. Even companies that are respected industry leaders and have outperformed the market and their peers have been, and are being, attacked. And companies that have faced one activist may be approached, in the same year or in subsequent years, by other activists or re-visited by the prior activist. The past two years of substantial economic, societal and market shifts have created new vulnerabilities and opportunities for activists and for companies.

Although asset managers and institutional investors will often act independently of activists, the relationship between activists and asset managers and investors in recent years has encouraged frequent and aggressive activist attacks. A number of hedge funds have also sought to export American-style activism abroad, with companies throughout the world now facing classic activist attacks. In addition, the line between hedge fund activism and private equity continues to blur, with some

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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.

Traditional activism, focused on short-term profit, stock price and total shareholder return (TSR), continues alongside a new form of activism emphasizing climate and other environmental, employee/human capital, social and governance (ESG) considerations. The activism landscape has also evolved to include dual purpose activists who combine both TSR and ESG arguments, as well as “pincer attacks” from ESG and TSR activists acting independently or in concert against the same company.

The outcomes of recent economic and ESG-related proxy fights, activism campaigns and non-public activist approaches across industry sectors underscore the importance of advance preparedness to anticipate, prevent and respond to an activist attack. This includes not only the more traditional governance and economic components of activist campaigns, but also the ESG themes that some activists have been deploying in their attacks (including and subsequent to the Exxon proxy fight successfully waged by ESG activist Engine No. 1 last year). The new universal proxy card rule only increases the importance of being prepared.

For many years, we have been updating 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 the company by leaking or initiating rumors of an unsolicited takeover 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 acquirer, making a “stalking-horse” bid for 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.
- Aggressively criticizing a company’s governance, management, business and strategy, sustainability and ESG strategies, and presenting the activist’s own recommendations and business and ESG plans, through a “white paper” or other public documents or statements.

- Proposing a precatory proxy resolution for actions prescribed by the activist or the creation of a special committee of independent directors to undertake a strategic review to “maximize shareholder value” and/or meet ESG goals, especially with respect to environmental impact.
- 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.
- 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.
- Leveraging the 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 the activist’s arguments.
- Using stock loans, options, derivatives and other devices to accumulate positions secretly, announce surprisingly large, leveraged economic stakes or increase voting power beyond the activist’s economic equity investment.
- Pairing economic arguments with governance or ESG proposals, in an effort to garner support from proxy advisory and governance teams within institutional investors.
- Using sophisticated public relations, social media and traditional media campaigns to advance the activist’s arguments.
- Investing in significant diligence and third-party consulting services to analyze the target’s strategy, business, operating margins and/or ESG impact.
- Seeking to create divisions within the boardroom or between the board and management; several major activists have been successful in achieving such wedges.
- Reaching a company’s retail shareholders through Internet forums and social media channels, weekly mailings, telephonic outreach, local newspaper advertisements and user-friendly infographics.

- Hiring private investigators to create dossiers on directors, management and key employees and otherwise conducting aggressive “diligence.”
- Initiating or threatening litigation, including demands for books and records, sometimes concurrently with a proxy fight.
- 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.

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. We have long sought to correct this loophole, and potential reforms are under consideration.

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 strategy and portfolio, how it is balancing growth and profitability, margin priorities and pressures, its ESG issues and strategy, and its governance and executive compensation. 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, 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 at least seek to engage constructively with activists. 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 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:

- A small group of key officers plus legal counsel, investment banker, proxy soliciting firm and public relations firm.
- 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.
- Periodic updates to the company's board of directors.
- 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.

Shareholder Relations:

- The investor relations officer 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. The credibility that these officers have 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.
- Articulate, update and share the company's position on corporate purpose, employee priorities, material social issues, diversity, ESG and long-term sustainability in appropriate forums.
- 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 themes that an activist may be promoting or testing.
- Articulate and consistently maintain the company's basic strategic message while updating the strategy as circumstances warrant.
- 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. Be aware of ESG shortfalls against perceived corporate leaders even if they are not in the same industry. 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.
- Monitor changes in hedge fund and institutional investor 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. Pay close attention to investors who are known to enlist activist funds or deploy activist campaign tactics.
- Maintain regular contact with major institutional investors, including both portfolio managers and proxy voting/governance departments; CEO, CFO and independent director participation is very 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, including BlackRock, Capital Group, Fidelity, Invesco, State Street, TIAA, T. Rowe Price, Vanguard and Wellington, have established significant proxy departments that make decisions independent of ISS, 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 may be possible to defeat an activist attack supported by ISS by gaining the support of major institutional shareholders.

- Consider whether enhancements to company disclosures or updates to governance and oversight practices are appropriate in light of evolving shareholder expectations, including with respect to ESG.
- Monitor third-party governance and ESG ratings and reports and seek to correct inaccuracies.
- Monitor annual meeting vote results 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.
- Maintain up-to-date plans for contacts with media, regulatory agencies, political bodies, industry leaders and other stakeholders, and refresh relationships.
- Monitor investor conference call participants, one-on-one requests and transcript downloads.
- 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.

Prepare the Board of Directors to Deal with an 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, which may include advocating that an unnecessary special committee be formed.
- Keep the board informed of options and alternatives analyzed by management, and review with the board basic strategy, capital allocation, the portfolio of businesses, margins and corporate ESG strategies in light of possible arguments for spinoffs, share buybacks, increased leverage, special dividends, cost-cutting initiatives, a sale of the company or other structural or business changes or ESG reforms.

- Schedule periodic presentations by legal counsel and the investment banker to familiarize directors with the current activist environment and the company's preparation.
- Directors should guard against subversion of the responsibilities of the full board by the activists or related parties, and directors should be instructed to avoid being drawn into conversations with third parties and to 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.
- 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. The benefits of tenure and experience became apparent through the Covid-19 pandemic and other economic, geopolitical and supply chain shocks to industry, but 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, in addition to more broadly assessing director diversity, 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 involving a company's independent directors. A disciplined, thoughtful program for periodic meetings and other engagement initiatives is advisable.

Monitor Trading, Volume and Other Indicia of Activity:

- Employ 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.

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 respond, but failure to respond may have negative consequences, and in most cases response is desirable.
- No duty to discuss or negotiate, but usually advisable to meet with the activist and discuss the activist's criticisms 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); no outright rejection absent study; try to learn as much as possible by listening; 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.
- Generally no immediate duty to disclose; determine when disclosure may be required or desirable.
- Response to any particular approach should be specially structured; team should confer to decide proper response. 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.
- 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 the activist and have immediate public response contingencies ready in the event of any disclosure.
- 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.
- 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 and settlement should be pursued or explored and, if so, at what point in time.

Response to Public Communication:

- Initially, no response other than “the board will consider and welcomes input from its shareholders.”
- Assemble team quickly; inform directors.
- Call special board meeting for the board to meet with the team and consider the communication.
- Determine 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 also 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.
- 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 take investor temperature, 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.

- 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.
- 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 follow the recommendations of ISS 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, investors will listen.

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