

# M&A NOTES



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## TEN RULES FOR DEALING WITH ACTIVIST SHAREHOLDERS

In the last few years there has been a significant increase in shareholder activism. This increase is largely due to the substantial increase in the size and number of hedge funds and their willingness to undertake various actions to effect corporate change. Many hedge funds acquire relatively small stakes in public companies and thereafter press the board of directors and management of the target to undertake various actions designed to increase the target's share price or launch proxy contests to elect one or more directors to the target's board. Often multiple hedge funds invest in the same company and thereafter support each other's proposals or coordinate tactics and strategy with respect to the target, thereby increasing the pressure on the target.

The corporate changes that activist shareholders frequently seek include:

- Sale of the target
- Sale, spin-off or split-off of a division or subsidiary
- Share repurchase
- Special cash dividend
- Management changes
- Retention of an independent investment banker to evaluate value-enhancing actions
- Appointment to the board of one or more of their representatives or independent directors
- Redemption of a shareholder rights plan (i.e., a "poison pill") and/or the dismantling of other takeover management devices
- Precatory or binding shareholder proposals seeking to compel or pressure the target to take one or more of the foregoing actions

Despite a growing acceptance of activist shareholders and an increasing recognition that they can sometimes play a constructive role in effecting corporate change, the investment horizon of most hedge funds tends to be relatively short (generally three to five years) compared to that of other investors. Accordingly, the interests of hedge funds are often not aligned with other shareholders or the board and management of the target itself. Specifically, other shareholders with longer investment horizons may prefer to give the target's board and management more time to implement corporate strategies designed to increase shareholder value. Not surprisingly, the board and management themselves

are also likely to feel that implementation of those strategies is the best means to maximize shareholder value.

This article summarizes ten rules that should be followed by the board and management of a target that is the subject of one or more activist shareholders seeking to effect corporate change. The article is intended to serve as a guide to the board and management in determining how to respond to an activist shareholder, how to assess the threat posed by the shareholder and how to best respond to actions taken by the shareholder that the target feels are not in the best interests of the target and the majority of its shareholders.

## **1. Organize Team**

As soon as a shareholder undertakes or threatens to undertake an action to effect corporate change that the board and management of the target determine is not in the best interests of the target and the majority of its shareholders, the target should assemble a team of experienced outside advisors to advise the target. The team should generally consist of investment bankers, outside legal counsel (including counsel familiar with the corporate laws of the state of incorporation of the target), a proxy solicitor and a financial public relations firm.

This team should be assembled with a view toward advising the target's board and management on the nature of the threat presented by the activist shareholder, including (i) the likelihood of shareholder support for the action proposed by the activist shareholder, (ii) the target's vulnerability to a proxy contest, unsolicited tender offer or other hostile actions, (iii) possible defensive actions available to the target, (iv) possible negotiation strategies and compromises with the activist shareholder and (v) the best means to present the target's case to the target's overall shareholder base.

## **2. Determine Strategy**

As soon as possible after an activist shareholder surfaces, the target should decide upon a strategy to deal with the shareholder. Generally speaking, a target can adopt one of the following strategies:

- Negotiate with the activist shareholder and seek to reach a settlement
- Actively resist actions proposed by the activist shareholder
- Implement a "divide and conquer" strategy in

which concessions are offered to other significant shareholders to prevent the activist shareholder from being able to successfully obtain the requisite shareholder approval for its proposed action

- Adopt a "middle of the road" approach that includes elements of two or more of the foregoing strategies

A frequent compromise between an activist shareholder and a target involves the target's appointment to its board of one or more representatives of the shareholder or new, independent directors acceptable to the shareholder. Many activist shareholders prefer to have independent directors sympathetic to their cause appointed to the target's board rather than their own officers or employees to avoid being imputed with knowledge of material, non-public information regarding the target's affairs that would make it difficult for the shareholder to freely trade the target's common stock and other securities. Although some activist shareholders and targets agree that the activist shareholder can designate a board observer rather than an actual director, board observers create difficult attorney-client privilege issues for the target and for this reason should be carefully considered before being proposed or agreed to.

A settlement or compromise with an activist shareholder may also include or more of the following:

- An agreement to redeem a poison pill and/or a commitment not to adopt a new one unless the board determines that it is compelled to do so by its fiduciary duties or the shareholders of the corporation approve it
- An agreement to include a precatory proposal in the target's proxy statement and, if it is approved by a majority of the target's shareholders, to either implement the proposal or put forth a binding proposal at the following year's annual meeting
- An agreement to retain an investment bank acceptable to the activist shareholder to review value-enhancing steps available to the target, with a commitment to implement any recommendations made by the investment bank (assuming the target board can do so consistent with its fiduciary duties)

If a target decides to resist an activist shareholder's actions, it may wish to do one or more of the following:

- Undertake a public relations campaign and make shareholder presentations supportive of the policies and strategy of the incumbent board and management
- Meet with leading shareholder advisory firms such as Institutional Shareholder Services and Glass Lewis & Co. to seek to obtain their support for management's position regarding the activist shareholder's actions (or at least their agreement not to support the activist shareholder's proposals)
- Implement appropriate takeover management devices (to the extent not already in place)
- Commence litigation against the activist shareholder

Before undertaking any of the foregoing actions, however, the target should keep in mind that it will likely be criticized by the activist shareholder and others for using corporate funds to defeat a shareholder who purportedly is acting in the best interests of "all shareholders".

### 3. Don't Delay

The target should not delay in responding to an activist shareholder's actions as any delay may work against the target. A delay in responding to an activist shareholder's public criticism of the target will lend a degree of credibility to the shareholder and its criticism and undermine the effectiveness of the target's ultimate response. In addition, a delay by the target will allow the shareholder to build support among other like-minded shareholders. Time is particularly critical if the target's financial results in the upcoming quarters are expected to decline (or at best stay flat) compared to previous quarters. If the activist shareholder has threatened to launch a proxy contest or make a shareholder proposal in connection with the target's upcoming annual meeting that management deems not in the best interests of the target and its shareholders, the target and its advisers should determine as soon as possible whether there are any amendments to the target's bylaws or other actions (such as moving the date of the annual meeting forward) that might thwart the shareholder's intentions.

### 4. Review Existing Structural Defenses and Consider Adopting New Ones

Once an activist shareholder surfaces, the target should immediately review its existing takeover management devices to determine how vulnerable it is to a proxy contest or unsolicited tender offer. Specifically, a target should consider:

- Adopting a rights plan that would be triggered (or

amending an existing rights plan so that it would be triggered) by actions of the activist shareholder and/or those of other significant shareholders.

- Specifically, the target should consider providing that the rights be triggered if:
  - The target announces publicly that the following events have occurred:
    - One or more persons or groups that (i) have filed or are required by law to file a Schedule 13D or (ii) (x) meet the definition of a "private fund" (as used in the SEC's now-invalidated hedge fund rule) or a similar definition and (y) hold individually in excess of 1% of the target's outstanding common stock (a person or group referred to in clause (i) or (ii), a "Covered Person"), collectively hold in excess of a specified percentage (e.g., 10%) (the "Trigger Threshold") of the target's outstanding common stock
    - One or more of the Covered Persons has publicly declared its intention to pursue one of the actions enumerated in Item 4 of Schedule 13D, either in a Schedule 13D or a press release or otherwise
  - Within a specified time period (e.g., 10 business days) after the foregoing announcement by the target, Covered Persons holding a sufficient number of shares of common stock have failed to either (i) file a Schedule 13G or (ii) issue a press release, in either case stating that they do not intend to undertake or support any action enumerated in Item 4 of Schedule 13D, such that Covered Persons who have failed to take either such action continue to collectively hold shares of common stock in excess of the Trigger Threshold.
- Whether there are any amendments to its bylaws that could thwart actions by the shareholder that are not in the best interests of the target and a majority of its shareholders. These amendments might include:
  - Eliminating the right of shareholders to call special meetings or extending the advance notice requirements for the calling of such a meeting
  - Giving the board more flexibility to accelerate the date of the annual meeting

- Extending the advance notice requirements for director nominations and/or shareholder proposals
- Adopting a provision or provisions subjecting any Covered Person (as defined above) to certain requirements, such as (i) providing detailed information to the target about the Covered Person, (ii) notifying the target of any communications with other shareholders regarding the target (or regarding any of the actions enumerated in Item 4 of Schedule 13D) and/or (iii) longer advance notice requirements than other shareholders.

To placate the activist shareholder or other shareholders, the target may wish to dismantle or amend one or more takeover management devices that are not necessary in light of the threat posed by the activist shareholder. For example, the target may redeem its rights plan or make it more "shareholder friendly" by amending it to include a "chewable" feature pursuant to which the board must redeem it after a certain period of time or under certain circumstances.

## 5. Assess Activist Shareholder

In determining the best way to respond to an activist shareholder, a target should learn as much as possible about the shareholder, including, if possible:

- Who controls it
- Who are its primary investors
- What is its investment history, i.e., what other companies has the shareholder invested in and how have those investments performed
- Whether it is aligned with other shareholders of the target
- Whether the shareholder has made money to date on its investment in the target
- What tactics the shareholder has used in the past with respect to its other investments
- Whether the shareholder had evinced a willingness to institute litigation against the target and/or its affiliates to achieve its objectives

To the greatest extent possible, the target should seek to determine the goals of the shareholder, e.g., is the shareholder seeking board representation, control of the target, a sale of the target or one of its subsidiaries or

divisions or a change of management or corporate strategy? The target should also seek to identify any weaknesses the activist shareholder may have, such as a limitation on human or financial resources sufficient to undertake a protracted battle for control of the target, past problems with regulators or antitrust issues that the shareholder might encounter in acquiring the target.

## 6. Assess Shareholder Base

In addition to learning as much as possible about the activist shareholder and its motives, the target should develop a thorough understanding of its own shareholder base. Working with its proxy solicitor, the target should first determine the make-up of its shareholder base, i.e., which institutional investors (e.g., mutual funds, pension plans, insurance companies, etc.), hedge funds and individuals beneficially hold its shares (and thus have the right to vote or to direct the voting of the shares), and how many shares each of them holds. Second, the target should seek to determine which of its shareholders are likely to be sympathetic to, and to vote in favor of, the positions and actions being espoused by the activist shareholder.

With respect to institutional shareholders and hedge funds that have not publicly taken a position regarding the activist shareholder's proposed actions, the target can seek to determine their positions vis-à-vis the proposed actions through a variety of means, including:

- Reviewing other investments by these shareholders to see (i) if they have invested side-by-side with the activist shareholder in the past and (ii) what (if any) activist stances these shareholders have taken with respect to other investments
- Analyzing the investment base of these shareholders to seek to determine if their investors are likely to support an aggressive, activist stance

In addition, it is likely that shareholder advisory firms will take a position with respect to any proposal of the activist shareholder requiring a vote of the target's shareholders. Accordingly, the target should seek (i) the support of these firms for the management's position regarding the activist shareholder's proposals requiring a shareholder vote, (ii) to determine as early as possible the recommendation of these firms with respect to these proposals and (iii) to determine which of its shareholders are likely to follow the recommendations of these firms. In seeking to determine how shareholders are likely to vote on the activist shareholder's proposals and the ultimate outcome of any vote, the target's proxy solicitor will play a critical role.



## 7. Evaluate Legal Arguments And Challenges Against Activist Shareholder

If a target elects to follow a strategy of resisting the activist shareholder's actions, the target should explore any legal arguments and challenges that it may have against the shareholder. These legal arguments and challenges may include the following:

- Failure to comply with Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act"), the rules and regulations promulgated thereunder and Schedule 13D. Possible arguments in this regard include:
  - Failure to timely file a Schedule 13D or to convert a Schedule 13G to a Schedule 13D
  - Failure to satisfy the disclosure requirements of Schedule 13D, including failure to adequately disclose the purpose of the shareholder's investment in the target or the existence of a "group" within the meaning of Rule 13d-5(b)
- Failure to timely make a required filing under the Hart-Scott-Rodino Antitrust Improvements Act of 1976
- Violation of applicable state takeover management statutes, such as business combination statutes, fair price statutes and control share statutes
- Violation of the short swing trading prohibition of Section 16(b) of the Exchange Act

If the target believes that the activist shareholder likely violated one or more of the foregoing statutes or rules, the target will need to decide whether it can and should pursue the matter directly against the shareholder by instituting litigation itself or refer the matter to the applicable regulatory authority such as the SEC, the Department of Justice or the applicable state regulator. A finding by a court, the SEC or another regulatory authority that the activist shareholder actually violated a federal or state law or an SEC rule could have a very damaging effect on the activist shareholder and threaten its ability to operate and raise money in the future. Even if litigation instituted by the target or a regulatory action pursued by a regulatory authority does not ultimately result in a finding of a violation by the activist shareholder, defending the litigation or regulatory action will likely result in additional costs and distractions, as well as reputational damage, for the activist shareholder. Of course, any

litigation pursued by the target will also increase the costs to the target of resisting the activist shareholder's actions and subject the target to accusations by the activist shareholder and others that pursuing the litigation is not a prudent or appropriate use of corporate funds. For these and other reasons (including avoiding allegations of instituting a frivolous lawsuit), a target should be confident that it has legitimate, bona fide claims against the activist shareholder before commencing any litigation.

## 8. Get Your Message Out To Shareholders

It is crucial for any target confronting an activist shareholder that has publicly disclosed its intentions with respect to the target to engage in an effective, ongoing shareholder relations campaign. As discussed above, in most cases it will probably be prudent for the target to retain a financial public relations firm to assist it in shaping and disseminating the target's message. The message will need to be tailored to the actions proposed by the activist shareholder and to the activist shareholder itself. For example, if the activist shareholder has publicly attacked the target's strategic direction or the board's and management's competence in managing the target, the target should undertake an aggressive PR and shareholder relations campaign (including the issuance of press releases and shareholder meetings) to rebut the shareholder's assertions and effectively communicate the target's successes and its strategic vision for the future.

The target should consider criticizing, to the extent accurate, the activist shareholder's short term outlook, past investment performance, lack of operating history, any regulatory problems encountered by the activist shareholder, etc. In addition, if the activist shareholder has launched or threatened to launch a proxy contest, the target should extol the experience and expertise of its directors being challenged and criticize the shareholder's proposed directors. In opposing any proxy contest or shareholder proposal submitted by an activist shareholder for consideration at an annual meeting, the target should ensure that any shareholder relations campaign is undertaken in advance of when most shareholders are likely to submit their proxies to the target or the activist shareholder.

## 9. Monitor Developments and Be Flexible

A target confronting an activist shareholder should actively monitor the situation. In this regard, the target should:

- As noted earlier, hire a proxy solicitor to (i) facilitate and shape communications with shareholders, (ii) advise the target regarding the

likely outcome of any shareholder vote and (iii) monitor material changes to its shareholder base, including any significant new shareholders who may be likely to support an activist agenda

- Monitor all press reports regarding the situation
- Maintain a dialogue with major shareholders regarding the situation

If a target's strategy for dealing with an activist shareholder does not appear to be working, the target should consider changing strategies. For example, if the target has attempted to negotiate with the activist shareholder to reach a settlement and the shareholder continues to pursue a belligerent path and shows no willingness to compromise, the target should probably switch to a strategy of active resistance that includes a shareholder relations campaign and may include offensive litigation. If the target aggressively opposed a slate of directors nominated, or a shareholder proposal submitted, by an activist shareholder and the target concludes (based on reports from its proxy solicitor or other evidence) that it will likely lose the vote, the target should consider changing strategies and possibly offering the activist shareholder greater concessions to withdraw its director nominees or shareholder proposal.

## **10. Be Magnanimous in Victory or Defeat**

If the target prevails in its confrontation with an activist shareholder -- by successfully getting the management slate of directors re-elected to the board,

defeating a shareholder proposal or otherwise -- the target should take the high road, not criticize the activist shareholder and seek to establish a constructive relationship with the shareholder going forward. It is important for the target to remember that even though the activist shareholder may have been defeated this time, that particular shareholder or another activist shareholder might pursue an activist agenda in the future, so it is prudent to maintain the best possible relations with all potential activist shareholders.

If the activist shareholder prevails in its confrontation with the shareholder, and particularly if the shareholder is able to elect -- or the target agrees to appoint -- one or more nominees of the activist shareholder to the target's board, the target should both publicly and privately welcome the new directors to the board and work constructively with them in seeking a compromise between management's agenda and strategy for the target and the agenda and strategy of the new director(s). Antagonizing the activist shareholder and its allies will likely lead to more activism against the company in the future. In addition, being magnanimous will build support among all shareholder constituencies.

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