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Managing shareholder activism in a new era

Briefing

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Shareholder activism traces its roots back to the Great Depression but has exploded during the past few decades. Today, we are living in what some call the "golden age of activist investing."[1] Activist investors, by definition, agitate for corporate change through their status as shareholders. They focus on an array of corporate issues, including corporate governance, mergers and acquisitions, cash dividends and stock buybacks, spin-offs, company strategy, and operations. And, they target companies both small and large. In recent years, companies such as Apple, Hess, JPMorgan Chase, Proctor & Gamble, and Sony have all been subject to activist campaigns.

Public pension funds have joined the fray alongside prominent activist investors such as Carl Icahn, Bill Ackman, Paul Singer, and Daniel Loeb. Indeed, shareholder activism has become its own asset class, with an ever-expanding universe of hedge funds dedicated to activism, and mutual funds such as the 13D Activist Fund allowing ordinary investors to participate financially in activist campaigns.[2]

Activist investors have waged an extensive campaign to eliminate the "corporate-raider" stigma from 1980s-era activism and have found success by drawing support from numerous constituencies. Mainstream investors and strategic bidders are working in increasing numbers with activists.[3]

1 Nathan Vardi, *The Golden Age of Activist Investing*, Forbes (Aug. 6, 2013, 8:25 AM), http://www.forbes.com/sites/nathanvardi/2013/08/06/the-golden-age-of-activist-investing/.
2 Grace L. Williams, *13D Fund: Invest Like Carl Icahn and Other Corporate Raiders*, Barron's (Jul. 1, 2014), http://online.barrons.com/news/articles/SB50001424053111904544004579650260175592246.
3 As an illustration, Bill Ackman recently teamed up with Valeant Pharmaceuticals International Inc. in an attempt to take over Allergan Inc. *See* David Gelles et al., *Ackman and Valeant Prepare Unusual Hostile Bid for Maker of Botox*, N.Y. Times (Apr. 21, 2014, 5:19 PM), http://dealbook.nytimes.com/2014/04/21/william-ackman-and-drug-maker-prepare-bid-for-botox-maker/?_php=true&_type=blogs&_r=0.

Institutional investors are investing in activist funds.[4] The financial press dedicates a beat to the goings-on of shareholder activists. Academics are supporting activist campaigns.[5] And shareholder advisory firms, such as Institutional Shareholder Services ("ISS") and Glass Lewis, are frequently siding with the activists in making voting recommendations to shareholders.[6]

The success of the recent wave of activism has manifested in many ways. In the 2014 proxy season, for example, shareholder proposals for board declassification and majority voting in director elections received record shareholder support, respectively averaging 84% and 57.2% of votes cast.[7] Additionally, in 2013 and 2014, shareholders successfully obtained board seats at eBay[8] and Microsoft,[9] achieved a higher price-per-share during Dell's going-private transaction,[10] and incited a division spin-off at Timken.[11] In light of recent activist success and prevailing shareholder sentiment, many corporate boards now proactively eliminate certain activist defensive measures such as staggered boards and protective bylaw provisions.[12]

Corporate boards and management should be proactive in managing activist risk and should be aware of available defensive measures when faced with an activist campaign that may not be in the best interests of the company or its shareholders. The intent of this paper is to assist boards and management in confronting this issue by: (1) providing an overview of the various types of action or change sought by shareholder activists; (2) outlining the means by which management can identify an activist campaign; (3) recommending proactive and defensive strategies to prepare for and defend against actions that are not in the best interests of the company or its shareholders; and (4) discussing relevant legislative developments that may impact shareholder activism.

Types of activism

Shareholder activism takes many forms. Areas of focus for activist shareholders include corporate governance matters, potential strategic transactions, returning capital to shareholders, and improving business operations.

Governance activism

Activist investors frequently demand corporate governance reforms, including changes to personnel and structure.

Management changes

Activist shareholders often seek to replace senior corporate officers that are perceived as underperforming. In 2012, for example, Bill Ackman's Pershing Square Capital Management accumulated a $2 billion stake in Procter & Gamble and pressured the company to replace its CEO.[13] The following year, the CEO resigned and was replaced by his predecessor.[14] Pershing Square thereafter exited its stake in the company.[15] Mr. Ackman's fund has also mounted high profile campaigns to replace the CEOs of Canadian Pacific Railway, Air Products & Chemicals Inc., and J.C. Penney.[16]

Board changes

Shareholder activists frequently seek changes in the membership and structure of corporate boards. Activist hedge funds repeatedly seek to defeat sitting directors or obtain expanded board seats as a means for increasing their influence, as demonstrated by Third Point's recent successful campaign to obtain three seats on Sotheby's board.[17] Activist shareholders also commonly seek structural changes, including declassification (so that all directors must stand for election each year), the separation of the chairman/CEO role, and the elimination of supermajority provisions. In 2012, the Harvard Law School Shareholder Rights Project submitted

4 Anupreeta Das & Sharon Terlep, *Activist Fights Draw More Attention*, Wall St. J. (Mar. 18, 2013, 11:23 PM), http://online.wsj.com/news/articles/SB10001424127887324392804578360370704215446.

5 Professor Lucian Bebchuk, Director of the Program on Corporate Governance at Harvard University, is well known for his commentary in support of shareholder activists and has engaged in well-publicized debates with Martin Lipton on the issue. Noam Noked, *Lucian Bebchuk and Martin Lipton to Debate Blockholder Regulation*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (Nov. 6, 2012, 10:06 AM), http://blogs.law.harvard.edu/corpgov/2012/11/06/lucian-bebchuk-and-martin-lipton-to-debate-blockholder-regulation/.

6 This is important because some institutional investors only vote in accordance with the recommendations of proxy advisory services.

7 These numbers are based on voting results through June 13, 2014. *2014 Proxy Season Review*, Sullivan & Cromwell LLP (June 25, 2014), http://www.sullcrom.com/siteFiles/Publications/SC_Publication_2014_Proxy_Season_Review.pdf.

8 Ricardo Lopez, *Ebay and Activist Investor Carl Icahn Settle Proxy Fight*, L.A. Times (Apr. 10, 2014), http://articles.latimes.com/2014/apr/10/business/la-fi-mo-ebay-icahn-settle-fight-20140410.

9 Shira Ovide, *Activist Storms Microsoft's Board*, Wall St. J. (Aug. 30, 2013, 7:32 PM), http://online.wsj.com/news/articles/SB10001424127887323249045790453737166274460.

10 Richard Waters, *Dell Shareholders Back $24.8bn Buyout*, Fin. Times (Sept. 12, 2013, 3:52 PM), http://www.ft.com/intl/cms/s/0/f237e172-1bb8-11e3-b678-00144feab7de.html#axzz3AwfDMJ62.

11 Michael J. De La Merced, *Timken Agrees to Split in Two After Pressure from Activist Investors*, N.Y. Times (Sept. 5, 2013 6:54 PM), http://dealbook.nytimes.com/2013/09/05/timken-agrees-to-split-in-two-after-pressure-from-activist-investors/.

12 Randall Wood & Parker Schweich, *Take Cover: Preparing for Hostile M&A in this Difficult Economic Environment*, Orange County Business Journal (2010), http://www.cbjonline.com/a1ocbj/supplements/CFO_Guide_2010.pdf. Some, however, question the prudence of dismantling defensive measures. Liz Hoffman, *Bidders Pounce on Firms' Weakened Defenses*, Wall St. J, Aug. 26, 2014, at C1.

13 David Benoit, *Pershing Square Slashes Procter & Gamble Stake*, Wall St. J. (Feb. 14, 2014, 7:25 PM), http://blogs.wsj.com/moneybeat/2014/02/14/pershing-square-slashes-procter-gamble-stake/.

14 *Id.*

15 *Id.*

16 *Id.*; *see also* Svea Herbst-Bayliss et al., *Ackman's Pershing Square Takes $2.2 Billion Stake in Air Products*, Reuters (July 31, 2013, 6:09 PM), http://www.reuters.com/article/2013/07/31/us-ackman-acquisition-idUSBRE96U0GK20130731.

17 Svea Herbst-Bayliss, *Sotheby's Ends Fight with Third Point, Loeb Joins Board*, Reuters (May 5, 2014, 12:25 PM), http://www.reuters.com/article/2014/05/05/us-sothebys-thirdpoint-idUSBREA440EC20140505.

87 board declassification proposals.[18] In 2014, activist hedge fund Sandell Asset Management sued Bob Evans Farms to eliminate the company's requirement that bylaws cannot be amended without 80% supermajority approval.[19] Sandell withdrew the lawsuit after the company agreed to relax the voting requirement.[20] Activist investors have also pressured companies to improve racial and gender diversity on their boards and to allow for proxy access (*i.e.*, the ability for shareholders to place their own director candidates on the ballot).[21]

Activist shareholders occasionally mount campaigns to vote against individual directors who support policies that the activist opposes. In a "just vote no" campaign, an activist shareholder encourages its fellow shareholders to withhold votes from one or more directors in order to express shareholder dissatisfaction.[22] Typically, this encouragement process will take the form of a campaign using letters, press releases, or online communications or a combination of the three. A GovernanceMetrics International study published in August 2012 found that roughly half of these majority withhold votes are in response to best practices concerns such as poison pills, poor director attendance at board and committee meetings, and related party transactions; another quarter or so dealt with company-specific considerations such as director compensation or more general investor dissatisfaction.[23]

Special interest activism

Activists also focus on social, political, and environmental change. In 1976, the SEC did an about-face on its previous position regarding shareholder proposals concerning such matters. Previously, the SEC almost categorically allowed companies to exclude special interest shareholder proposals from their proxy statements based on the fact that such proposals concern matters "relating to the company's ordinary business operations."[24] After an adverse ruling by the DC Circuit in a case related to a shareholder proposal about Dow Chemical Company's manufacture of napalm,[25] the SEC reversed course and issued Release No. 9784.[26] After the release, it was clear that companies could omit shareholder proposals that primarily promoted general, economic, political, racial, religious, social or similar causes only if the causes addressed by the proposal were not significantly related to the company's business, or if the action requested by the proposal was outside the company's control.[27]

This position change had an immediate impact on the volume of social proposals. Today, special interest proposals play a major part in every proxy season. During the 2014 proxy season, shareholders submitted 178 proposals on social and political issues.[28] Although only 4 proposals passed, social and political proposals remain influential.[29] For instance, in the 2013 proxy season, McDonald's Corporation faced a proposal requesting the board to "report to shareholders . . . on McDonald's process for identifying and analyzing potential and actual human rights risks of McDonald's operations (including restaurants owned and operated by franchisees) and supply chain . . . ."[30] The proposal only garnered 28% of shareholder support, but McDonald's nonetheless opted to make the requested report.[31]

Recently shareholders have been focusing heavily on political issues, with 81 of the 178 special interest proposals centered on political concerns.[32] These proposals typically ask for one of two things (1) advisory votes or flat-out prohibitions on political spending or (2) expanded disclosure of political expenditures and lobbying costs.[33] The proposals in the latter category typically receive much higher support than the proposals in the former category,[34] which has caused companies to take steps to affirmatively report political spending.

Compensation reform

Shareholders continue to focus on executive compensation practices. While public companies are already required to

18 Steven Davidoff Solomon, *The Case Against Staggered Boards*, N.Y. Times (Mar. 20, 2012, 12:43 PM), http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards/.
19 Alexandra Stevenson, *Activist Investor Takes Bob Evans Farms to Court*, DealBook, N.Y. Times (Jan. 14, 2014, 9:26 AM), http://dealbook.nytimes.com/2014/01/14/activist-investor-takes-bob-evans-farms-to-court/.
20 Mary Vanac, *Investor Drops Suit against Bob Evans Farms*, The Columbus Dispatch (Jan. 30, 2014, 5:49 AM), http://www.dispatch.com/content/stories/business/2014/01/29/activist-shareholder-drops-bob-evans-suit.html.
21 Eleanor Bloxham, *Activist Shareholders' Top Priorities for 2014*, Fortune (Jan. 6, 2014, 5:23 PM), http://fortune.com/2014/01/06/activist-shareholders-top-priorities-for-2014/. Dodd-Frank authorized the SEC to adopt a proxy access regime and the SEC did so in 2010. But the SEC's proxy access rules were struck down by the D.C. Circuit Court. *See Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).
22 Noam Noked, *Corporate Director Elections and Majority Withhold Votes*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (Sept. 1, 2012, 9:01 AM), http://blogs.law.harvard.edu/corpgov/2012/09/01/corporate-director-elections-and-majority-withhold-votes/.
23 *Id.*
24 Jay W. Eisenhofer & Michael J. Barry, Shareholder Activism Handbook, § 3.03[B] (Wolters Kluwer Law & Business, Supp. 2013).
25 *Medical Committee for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972).
26 *See* Solicitation of Proxies, Exchange Act Release No. 9784 (Oct. 31, 1972).
27 Thomas A. DeCapo, Note, *Challenging Objectionable Animal Treatment with the Shareholder Proxy Proposal Rule*, 1988 U. Ill. L. Rev. 119, 140.
28 These numbers are based on voting results through June 13, 2014. *2014 Proxy Season Review*, Sullivan & Cromwell LLP (June 25, 2014), http://www.sullcrom.com/siteFiles/Publications/SC_Publication_2014_Proxy_Season_Review.pdf.
29 *Id.*
30 Report of the Sustainability and Corporate Responsibility Committee of the Board of Directors of McDonald's Corporation, McDonalds (Jan. 9, 2014), http://www.aboutmcdonalds.com/content/dam/AboutMcDonalds/Investors/Investor%20 2014/Human%20Rights.pdf.
31 *Id.*
32 These numbers are based on voting results through June 13, 2014. *2014 Proxy Season Review*, Sullivan & Cromwell LLP (June 25, 2014), http://www.sullcrom.com/siteFiles/Publications/SC_Publication_2014_Proxy_Season_Review.pdf.
33 *Id.*
34 *Id.*

conduct periodic advisory say-on-pay votes under the Dodd-Frank Act, activist shareholders have pressured companies to tie executive pay more directly to annual performance and to disclose instances when executive pay is clawed back due to misconduct.[35]

Companies have also taken aim at the activist funds' own compensation policies. In particular, several dozen companies adopted so-called "golden leash" provisions as of November 2013, which prohibit funds from paying additional compensation to funds' director nominees (under the theory that these payments are inconsistent with the directors' duties to represent the company and shareholders at large).[36] In January 2014, however, ISS announced that it would consider the adoption of such measures a material failure of governance.[37] Despite ISS opposition, in some circumstances companies may be able to accomplish the goals of "golden leash" provisions by enacting bylaws allowing for a one-time candidacy payment, or requiring candidates to disclose any and all financial arrangements with third parties.[38] The latter is clearly permissible according to the ISS's statement, which expressly did not oppose bylaws that disqualify candidates for failing to disclose third-party arrangements.[39]

M&A and strategic alternatives activism

Activist shareholders frequently pressure companies to engage in strategic transactions. In many instances, the activist seeks to reap a short-term increase in the stock price from the desired action (or the marketplace exuberance generated by the mere possibility of such a transaction), with the goal of exiting the stock shortly after the action is taken. An article posted in the Harvard Law School Forum on Corporate Governance and Financial Regulation identified three primary strategies employed by activists on this front: (i) targeting or interfering with a currently announced transaction; (ii) acquiring shares in the target company with the intent of exercising appraisal rights; and (iii) making unsolicited proposals or publicly agitating for companies to consider strategic alternatives.[40]

Attacking pending M&A transactions

Activist shareholders frequently inject themselves into contentious M&A transactions after they are publicly announced. Recent examples include Carl Icahn's campaign to defeat Dell's going private transaction (which was approved after the private equity sponsor agreed to increase the transaction consideration by $350 million) and Paulson & Co.'s public criticism of the debt load in the T-Mobile-MetroPCS transaction (which was revised to reduce the amount of debt borne by the combined company).[41] Activists engage in a variety of tactics to challenge M&A transactions, including public criticism, soliciting proxies, lobbying institutional stockholders and proxy advisors, proposing alternative transactions or terms, and publicly attacking the officers and directors who approved the transaction.[42] And, activists often oppose proposed transactions on the grounds that they are, among other things, over-dilutive, not of strategic value, too favorable to insiders, or result in further entrenching the existing board and management team.

Pursuing appraisal rights

The New York Times recently described the pursuit of appraisal rights by activists in merger transactions as "the new, new thing on Wall Street. . . ."[43] Shareholders sought more than $1.5 billion in appraisal claims last year, which is ten times the amount sought in 2004.[44] Part of Icahn's strategy for challenging Dell's buyout was to encourage other shareholders to exercise their appraisal rights.[45] Activist funds also targeted Dole's management buyout last year, purchasing 14 million shares and exercising their appraisal rights.[46] One of those funds, Merion Capital, is run by former shareholder plaintiff lawyer Andrew Barroway, whose firm obtained a $2 billion judgment against Southern Peru Copper (the largest Delaware Court of Chancery judgment ever).[47]

Unsolicited offers

Activist funds have also made unsolicited acquisition proposals as an attempt to put the company in play and stimulate market reaction.[48] Examples include Icahn's offer to acquire Clorox in 2011 after purchasing more than 9% of the outstanding shares and Pershing Square's involvement

35 Christopher Skroupa, *Shareholder Activism Shops at Walmart*, Forbes (June 9, 2014, 6:31 PM), http://www.forbes.com/sites/christopherskroupa/2014/06/09/shareholder-activism-shops-at-walmart/.
36 *Id.*
37 Saeed Teebi, *ISS Pulls the 'Golden Leash,' But Has It Gone Too Far?*, Mondaq (Feb. 3, 2014), http://www.mondaq.com/canada/x/290618/Shareholders/ISS+Pulls+The+Golden+Leash+But+Has+It+Gone+Too+Far.
38 Martin Lipton, *ISS Publishes Guidance on Director Compensation (and Other Qualification) Bylaws*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (Jan. 16, 2014, 2:16 PM), http://blogs.law.harvard.edu/corpgov/2014/01/16/iss-publishes-guidance-on-director-compensation-and-other-qualification-bylaws/.
39 *Id.*
40 Spencer D. Klein, Enrico Granata, & Isaac Young, *Activist Hedge Funds Find Ways to Profit from M&A Transactions*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (June 4, 2014, 9:28 AM), http://blogs.law.harvard.edu/corpgov/2014/06/04/activist-hedge-funds-find-ways-to-profit-from-ma-transactions/.
41 *Id.*
42 *Id.*
43 Steven Davidoff Solomon, *A New Form of Shareholder Activism Gains Momentum*, N.Y. Times (Mar. 4, 2014, 6:16 PM), http://dealbook.nytimes.com/2014/03/04/a-new-form-of-shareholder-activism-gains-momentum/?_php=true&_type=blogs&_r=0.
44 *Id.*
45 *Id.*
46 *Id.*
47 *Id.*
48 Spencer D. Klein, Enrico Granata, & Isaac Young, *Activist Hedge Funds Find Ways to Profit from M&A Transactions*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (June 4, 2014, 9:28 AM), http://blogs.law.harvard.edu/corpgov/2014/06/04/activist-hedge-funds-find-ways-to-profit-from-ma-transactions/.

in Valeant Pharmaceuticals International's offer to purchase Allergan.[49] Activist funds may continue to collaborate with strategic acquirers in making unsolicited bids.[50]

Greenmail

Some activist shareholders have also purchased large quantities of shares and threatened to launch a takeover battle (or other disruptive activist campaign) unless the company buys back their shares at a premium.[51] WebMD and Corvex Management, for example, purchased shares from activist shareholders last year.[52]

Balance sheet activism

Shareholder activists have also pressured companies to return more cash to shareholders through dividend hikes, special dividends, share buybacks, and spin-offs.[53] Some activists have pushed energy companies to employ a master limited partnership structure.[54] With higher oil prices, high oilfield costs, and a three-year trend of stock underperformance versus other sectors, energy companies have faced particular pressure to improve cash returns to shareholders.[55] Companies with a significant amount of cash on their balance sheet and a history of poor returns or underperforming assets are prime candidates for balance sheet activists.[56] Apple, for example, faced an activist campaign from Carl Icahn to increase its stock repurchase plan by $50 billion after the amount of cash on its balance sheet swelled to $150 billion.[57]

Operational activism

Companies with stale products, stagnant growth, and underperforming business units are also facing pressure on the activist front. In a recent presentation, Alliance Advisors cited several examples of "operational activist" proposals, including a successful proposal to spin-off Timken's steel business, Carl Icahn's proposal to spin-off eBay's PayPal business, and Starboard's proposal opposing the Darden's separation into two operating companies and a REIT.[58] Companies may attract operational activists if the market has placed a discount on part of the company's assets or business.[59] Operational activists may push companies to cut costs, eliminate underperforming business lines, or pursue new business strategies.

Identifying an activist campaign and activist tactics

To adequately prepare for and respond to an activist campaign, management must recognize it early and be familiar with activist tactics.

Identifying an activist campaign

Private activism

One common way that management becomes aware of an activist is through a private approach. Private activism is sometimes referred to as "quiet diplomacy" and includes private negotiations with management, behind-the-scenes consultations, letters, phone calls, meetings, and ongoing dialogues.

The SEC made private activism more accessible to investors in 2004 when it amended the information required in proxy statements. The SEC made the amendments to provide shareholders with a means by which to communicate with members of the board of directors and improve the transparency of board operations, as well as security holder understanding of the companies in which they invest.[60] Now, companies must disclose the process for communicating with board members or explain why they do not have such a process.[61]

Private activism is attractive to investors (and management) because it is less hostile than public advocacy, builds sustainable relationships between management and shareholders, and engenders consensuses. This activist approach also has the lowest probability to impair share value during the activist campaign.

49 *Id.*
50 *Id.*
51 Spencer D. Klein & Enrico Granata, '*Greenmail*' *Makes a Comeback*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (Jan. 22, 2014, 9:12 AM), http://blogs.law.harvard.edu/corpgov/2014/01/22/greenmail-makes-a-comeback/. Some states have adopted provisions that prohibit companies from making greenmail payments and others require investors that engage in greenmail to disgorge profits. *Id.*
52 *Id.*
53 FTI Consulting, *Shareholder Activism: Protecting Energy Companies from the Growing Threat of Activist Investors*, FTI Consulting (2013), http://www.fticonsulting.com/global2/media/collateral/united-states/shareholder-activism.pdf.
54 *Id.*
55 *Id.*
56 Christopher Westfall, *Your Balance Sheet is a Sitting Duck*, Fin. Execs. Int'l, (Mar. 31, 2014, 6:34 AM), http://daily.financialexecutives.org/your-balance-sheet-is-a-sitting-duck/.
57 James Constas, *Shareholder Activism*, Oil & Gas Fin. J. (June 9, 2014), http://www.ogfj.com/articles/print/volume-11/issue-6/on-the-cover/shareholder-activism.html.
58 Shirley Westcott, *Shareholder Activism Webinar: Dealing with Evolving Activist Investor Strategies*, Alliance Advisors (2014), http://allianceadvisorsllc.com/wp-content/uploads/2014/03/Alliance-Advisors-March-12-2014-Webinar-Deck.pdf.
59 Abby E. Brown & Wendy K. LaDuca, *When Activists Come Knocking*, Lexology (June 20, 2014), http://www.lexology.com/library/detail.aspx?g=b0db8c47-f6f1-4672-bedd-42bed5e931a3.
60 *See* Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Exchange Act Release Nos. 33-8340; 34-48825 (Jan. 1, 2004).
61 *Id.*

The efficacy of private activism, however, generally depends on how approachable the board and management teams are seen to be in the market. For example, if an issuer is seen to have a smart board of directors or lead directors with a good reputation, activists view this approach favorably. If on the other hand, there is a sense that the existing board is very entrenched or too friendly with management and will do anything it takes to stay in power, activists view this approach as somewhat fruitless. Nonetheless, private activism is the most used and generally regarded as the most successful form of activism.

Public activism and media campaigns

In some instances (especially when management is viewed as unapproachable), activist shareholders find it necessary to campaign for corporate reform publicly. They do so through tools such as 13Ds (discussed below), open letters (also known as "shot across the bow" letters), publicly circulated whitepapers, and broadcast presentations. Daniel Loeb is well known for his "poison pen" letters in which he has chastised executives for everything from keeping relatives on the payroll to socializing at the US Open tennis tournament.[62]

Public activism usually follows unsuccessful private activism. The purpose of public activism is two-fold: (1) convince management to adopt a corporate change; and (2) persuade other shareholders to exercise their vote in favor of the recommended corporate change.

13D filings

An acute form of public activism is Schedule 13D filings. Under Rule 13d, an investor must file a Schedule 13D with the SEC within 10 days of acquiring beneficial ownership of more than 5% of a voting class of a company's securities when it has plans to communicate some strategic option for the company.[63] Activists use the 13D as a platform for stumping for management and shareholder support. For example, Engaged Capital made the following statements in the 13D it filed after acquiring a 5.7% stake in Medifast:

> [Engaged Capital] purchased the Shares based on the [its] belief that the Shares, when purchased, were undervalued and represented an attractive investment opportunity. . . .
>
> [Engaged Capital has] engaged in discussions with [Medifast's] management regarding improving the profitability of [Medifast's] operations, accelerating growth in [its] core business, and the adoption of a disciplined approach to capital allocation with a focus on return on invested capital. [Engaged Capital] intend[s] to continue to engage in discussions with [Medifast's] Board of Directors (the "Board") and management in hopes of enhancing value for all of [Medifast's] shareholders.
>
> [Engaged Capital has] communicated to [Medifast's] management that [it] believe[s] [Medifast] has multiple attractive attributes that are not being recognized by investors.[64]

Engaged Capital then went on to make clear what those attributes were. The goal of the statements in the 13D was to put pressure on management to make the changes that Engaged Capital sought. It has yet to be seen whether it has worked but there is a clear take-away from the Engaged Capital/Medifast 13D: that companies should be actively monitoring and responding as appropriate to 13D filings.

Because 13D filings highlight activists in the midst of a company's shareholders, activists have sought to avoid filing them. For example, some activists use derivatives to acquire a large stake in a company at once without prior notice.[65] And some activists work in parallel with other activists (in what some call a "wolf pack") without forming a "group" holding greater than 5%.

Requests for books and records

A request for books and records can be a telltale sign of an activist campaign. These requests are generally made under state corporate codes. For example, Section 220 of the Delaware General Corporation Law provides shareholders access to a Delaware corporations' books and records.[66] Regardless of how many shares a shareholder owns or for how long a shareholder has owned them, a shareholder is entitled upon written demand stating the purpose of the request, to inspect the corporation's stock ledger, a list of its stockholders,

62 Juliet Chung, *Biggest Chapter Yet for a Poison Pen*, Wall St. J. (July 30, 2012, 6:54 PM), http://online.wsj.com/news/articles/SB10000872396390444130304577559000855796614.

63 17 C.F.R. § 240.13d-101.

64 Medifast, Inc., General Statement of Acquisition of Beneficial Ownership (Schedule 13D) (May 14, 2014).

65 This was the case when an activist hedge fund acquired derivatives that represented over 5% of CSX corporation. Although the district court found that derivatives made the hedge fund the beneficial owner of over 5% of CSX shares so as to be required to file a 13D, the Second Circuit did not resolve the beneficial owner questions. *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 654 F. 3d 276 (2d Cir. 2011).

66 Del. Code Ann. tit. 8, § 220.

a list of beneficial owners of the corporation's stock, and its other books and records.[67]

The books and records request must be made for a proper purpose. The proper purpose requirement has been subject to extensive litigation. Most recently activists have been successful using books-and-records provisions to obtain information related to special interest issues, such as political spending records[68] and child labor issues.[69]

Activist tactics

Shareholder proposals and proxy solicitations

A mainstay tactic used by shareholder activists is the shareholder proposal. The process of submitting a shareholder proposal for inclusion on a proxy statement is governed by Securities and Exchange Commission Rule 14a-8. Specifically, any shareholder who has continuously held shares for one year worth at least $2000 or 1% of firm value may submit a proposal that is 500 words or less.[70] A company can exclude a shareholder proposal from its proxy materials in only limited circumstances.[71]

Shareholders make proposals for a number of reasons. During the 2014 proxy season, US public companies saw 185 proposals related to governance (including proposals requesting board declassification, majority voting in directors elections, elimination of supermajority requirements, separation of the roles of CEO and chairman of the board, and the right to call special meetings and act by written consent), 178 proposals related to social issues (with a heavy emphasis on political contributions and lobbying costs), and 58 proposals related to compensation issues.[72] Of those, 51 governance proposals passed, 4 social proposals passed, and 5 compensation proposals passed.[73]

In connection with a shareholder proposal (or with an attempt to obtain votes for or against another proposal), activists can solicit proxies from other shareholders. If they do so they are subject to the proxy solicitation rules in Rules 14a-3 to 14a-15.[74] One benefit of formal proxy solicitations, aside from the fact that an activist can solicit proxies for its own shareholder proposal, is that the activist can obtain shareholder lists or have the company mail its proxy solicitation to shareholders under Rule 14a-7.[75]

Private proxy solicitation and "testing the waters" solicitations

Aside from shareholder proposals and formal proxy solicitations, activists can influence a shareholder vote through private proxy solicitations. Under the SEC Rules, an activist can solicit an unlimited number of shareholders with no proxy or public disclosure as long as the activist does not ask for a proxy card or revocation and does not have a special interest in the subject matter of the solicitation.[76] If the activist who makes the solicitation holds more than $5 million of the company's stock, however, it must file any written solicitation with the SEC within three days of its use.[77] And notably, Schedule 13D filers who have disclosed a possible control intent are required to comply with the full proxy statement and disclosure requirements.[78]

Private solicitations are an important part of the activist tool kit because they permit private discussions among major shareholders outside of the purview of the company. Without a doubt, this increases the influence of institutional shareholders and strengthens the leverage they have when negotiating corporate change with management. Activists also use private solicitations to "test the waters" with major shareholders before launching a formal proxy solicitation.

"Vote no" campaigns or withhold the vote campaigns

In certain circumstances (as discussed above), activists attempt to promote change through "vote no" or withhold the vote campaigns. Vote no campaigns are a by-product of the shareholder private communication rules. In these campaigns, activists encourage other shareholders to vote against a corporate proposal or refrain from voting for an incumbent director. Vote no campaigns are used because they are often more cost effective and less time consuming than shareholder proposals and proxy solicitations.

Vote no campaigns are most commonly used against management-proposed directors. But, a study conducted by GMI Ratings and the Investor Responsibility Research Center Institute on withhold the vote director campaigns

67 *Id.*
68 Sinead Carew, *New York Fund Withdraws Political Spending Lawsuit Against Qualcomm*, Reuters (Feb. 22, 2013, 8:00 AM), http://www.reuters.com/article/2013/02/22/us-qualcomm-nylawsuit-idUSBRE91L0IT20130222.
69 Jef Feeley, *Hershey Investors Suing Over Child Labor Can Pursue Files*, Bloomberg (Mar. 18, 2014, 11:11 PM), http://www.bloomberg.com/news/2014-03-18/hershey-judge-says-shareholders-can-seek-child-labor-files-1-.html.
70 17 C.F.R. § 240.14a-1.
71 *Id.*
72 These numbers are based on voting results through June 13, 2014. *2014 Proxy Season Review*, Sullivan & Cromwell LLP (2014), http://www.sullcrom.com/siteFiles/Publications/SC_Publication_2014_Proxy_Season_Review.pdf.
73 *Id.*
74 17 C.F.R. § 240.14a-3 to 15.
75 17 C.F.R. § 240.14a-7.
76 17 C.F.R. § 240.14a-2(b)(1).
77 17 C.F.R. § 240.14a-6(g).
78 17 C.F.R. § 240.14a-2(b)(1).

confirmed that they are relatively rare and often unsuccessful.[79] That being said, vote no campaigns can still be valuable tool as part of a broader activist strategy or by forcing the resignation of complained-of directors. For example, directors at both Hewlett-Packard and JPMorgan Chase resigned after being subject to a vote no campaign even though they won reelection.[80]

Announcement of voting decisions
Another way in which activists attempt to influence shareholder votes is by announcing their voting decisions ahead of the shareholder vote. The SEC rules deem that a public announcement of voting intention does not constitute a proxy solicitation.[81] Several institutional investors, like CalPERS, have made it a practice to announce their voting decisions on their websites ahead of the vote.[82]

Additionally, proxy advisory firms make voting recommendations to shareholders in contested proxy situations. These proxy advisory firms typically support dissident proposals.

Special meetings, actions by written consent, and ambush proposals
Activists can also catch management off guard and promote corporate change by calling special meetings, taking action by written consent, or submitting ambush proposals at annual meetings.

The permissibility of special meetings is governed by state corporate law. Some states, like Delaware, only allow shareholders to call special meetings when the certificate of incorporation or bylaws authorize them to do so.[83] Others, such as California, require corporations to allow shareholders to call special meetings.[84] There is a wide variety of reasons that a shareholder would want to call a special meeting, including replacement of one or more members of the board.

In contrast to special meetings, most state corporate laws allow shareholders to take action by written consent.[85] Action by written consent can be eliminated by provisions in the governance documents. But assuming it has not been, it is an effective tool for activist shareholders.

Finally, assuming the governance documents do not include an advance notice provision, activist shareholders can submit for vote an ambush proposal at the annual meeting.[86] Even though ambush proposals are almost universally unsuccessful,[87] a threat of one can be meaningful leverage for an activist when negotiating with management.

Tactics used during mergers & acquisitions
Shareholder activists use myriad tactics to influence merger and acquisition transactions, as discussed above. These include tender offers, attacking transactions after they are announced, exercise of state law appraisal rights, encouragement of bear hugs, and use of greenmail.

Shareholder litigation
Activists also occasionally use litigation as part of their strategy. For example, litigation has been used to invalidate take-over and other activist preventive provisions in corporate governance documents and shareholder rights plans. Activists seeking to bring litigation, however, often face standing problems based on the date on which they acquired their shares and pre-suit demand requirements imposed by state corporate law, which limit the availability of litigation remedies for activist shareholders.[88]

Preparing for and responding to an activist campaign

Preparing for an activist

Advance preparation may give the board the tools it needs to appropriately respond to an activist shareholder and, if appropriate, resist actions that may not be in the best interests of the company or its shareholders. Undertakings companies may wish to consider include performing a vulnerability assessment, actively monitoring market activity, fortifying bylaws to include provisions such as advance notice requirements for director nominations and other proposals, establishing an internal response team, establishing a comprehensive communications plan, adopting a shareholder rights plan or "poison pill," and others.

79 *The Election of Corporate Directors: What Happens When Shareholders Withhold a Majority of Votes from Director Nominees?* IRRC Institute & GMI Ratings (2012), http://irrcinstitute.org/pdf/Final%20Election%20of%20Directors%20GMI%20Aug%202012.pdf.
80 *2014 Insights*, Skadden (2014), http://www.skadden.com/sites/default/files/publications/US_Corporate_Governance_Boards_of_Directors_Face_Increased_Scrutiny.pdf.
81 17 C.F.R. § 240.14a-1(1)(2)(iv).
82 James McRitchie, *Announcing Proxy Votes Improves Corporate Governance*, Corp. Governance (June 19, 2014), http://corpgov.net/2014/06/announcing-proxy-vote-advance-open-cdv/
83 *See, e.g.*, Del. Code Ann. tit. 8, § 211(d).
84 *See, e.g.*, Cal. Corp. Code § 600(d).
85 Consent Solicitations, The Activist Investor, http://www.theactivistinvestor.com/The_Activist_Investor/Consent_Solicitations.html (last visited Aug. 26, 2014).
86 Jill Priluck, *The Dark Side of Shareholder Activism*, Reuters (Apr. 12, 2013), http://blogs.reuters.com/great-debate/2013/04/12/the-dark-side-of-shareholder-activism/.
87 James R. Copland, *A Report on Corporate Governance and Shareholder Activism*, Proxy Monitor (2011), http://proxymonitor.org/Reports/Proxy_Monitor_2011.pdf.
88 Holly J. Gregory, *The Elusive Promise of Reducing Shareholder Litigation through Corporate Bylaws*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (June 19, 2014, 9:25 AM), http://blogs.law.harvard.edu/corpgov/2014/06/09/the-elusive-promise-of-reducing-shareholder-litigation-through-corporate-bylaws/.

Perform vulnerability assessment and monitor trading and market activity

Many boards will conduct an assessment, often with assistance of outside counsel, to understand the company's vulnerabilities and whether there are particular attributes that might make the company attractive to an activist campaign. Any such assessment should include a review of the company's corporate governance framework, including its certificate of incorporation and bylaws, as well as the company's known ownership structure and its investor relations program. It is often helpful to consider items such as whether the company has publicly and effectively articulated a strategy to increase shareholder value, how the company's stock has performed, shareholder sentiment as expressed at shareholder meetings and through correspondence and telephone calls, and the recent positions taken by shareholder advisory firms in connection with the company's annual meetings. Additionally, it is good practice to determine areas of perceived strength and weakness of the board and management team.

Companies should also understand the composition of their shareholders. This includes identifying the company's key current shareholders and the expectations, objectives, and time horizon of those shareholders. This also includes determining whether those shareholders vote in accordance with recommendations of proxy advisory firms.

Finally, companies should monitor market and trading activity, including Schedule 13 filings and statements from analysts, proxy advisors, large investors, and the news and other online media. Conducting research on Schedule 13 filers will often show whether such shareholders have engaged in prior activist activities, and whether two or more of the filers have previously acted together on any activist issues.

Establish response team

One of the most effective ways to avoid mistakes in responding to an activist shareholder is to create a response team composed of representatives from the executive team, the board, the legal department, and investor relations who will assess vulnerabilities, manage relationships with key stakeholders, gather market intelligence (preemptively and on a continual basis), and, in the face of an actual activist event, negotiate with the activist, draft and review press releases, and form a strategy. This team, which in many cases receives a primer on activist issues from the company's outside legal counsel, should ensure that all officers, directors, and other management personnel are aware that any approach by a potential activist should be referred to a designated individual who is a member of the team (such as the CEO or General Counsel). This team should also understand what fiduciary and other legal duties they owe and how those duties interact with activist investors.

When actually subject to an activist event, it is good practice to form a special committee of the board tasked with responding to activists. This avoids cumbersome processes associated with full board meetings and allows the board the flexibility to respond in a timely and efficient fashion to an activist campaign.

It is also important to engage outside advisors and third parties. Typical advisors and third parties include investment banks and financial advisors, outside legal counsel, communications and public relations firms, proxy solicitation firms, transfer agents, and analysts.

Establish comprehensive communication plan

A shareholder's plan to increase shareholder value has more appeal if there is no competing strategy articulated by the company. Companies may head off activist challenges, or limit their effectiveness, by maintaining a dialogue between key shareholders and management and cultivating the support of those shareholders. Companies should also take steps to maintain a consistent message, which may include designating a media representative and instructing others (including directors and officers) to refrain from commenting to the public or shareholders without using designated channels.

Fortify bylaws

Carefully crafted bylaws may provide a board with time and leverage in the face of an activist campaign. Advance notice requirements, for example, require shareholders to notify the company in advance of a shareholder meeting of any proposals or director nominations. These provisions help prevent against ambush proposals and give the company time to react to the proposal and, if appropriate, negotiate with the proposing shareholder. Other potential bylaw provisions that may provide time or leverage in the face of shareholder activism include:

- Provisions eliminating any requirement for the annual shareholder meeting to be held on a fixed date;
- Provisions allowing the board to accelerate the date of the annual meeting;
- Provisions permitting the Chairman to adjourn any meeting of shareholders irrespective of whether a quorum exists;
- Provisions restricting who may call a special meeting or what actions may be considered at a special meeting;

- Provisions prohibiting a board candidate who is nominated and paid by a shareholder from serving on the board;
- Provisions specifying that the Chairman has authority to control shareholder meetings;
- Provisions requiring board candidates to disclose any and all financial arrangements with third parties;
- Provisions prescribing qualifications for all nominees for election as directors, including abidance of board policies regarding confidential information;
- Provisions setting forth mandatory qualifications for any board nominees;
- Requirements that any proposing shareholder be a record holder of the company's shares;
- Forum selection provisions, arbitration provisions, and fee shifting provisions;
- Provisions providing the board with the exclusive right to fill board vacancies; and
- Provisions providing that directors may only be removed for cause and defining cause.

Certain bylaw provisions are viewed with disfavor by influential proxy advisory firms and corporate governance rating agencies.[89] Careful thought should be given to potential shareholder and market reaction prior to amending any bylaws, and the bylaws should be carefully reviewed by inside and outside counsel to ensure consistency with applicable state law.

Shareholder rights plans

A shareholder rights plan or poison pill typically provides that if a shareholder increases its ownership of the company's stock past a threshold percentage (usually 10 to 20 percent), all other shareholders may purchase additional shares at a steep discount (which substantially dilutes the shareholder that exceeded the threshold amount). Under Delaware law, a board's decision to implement a rights plan, or refuse to redeem the rights plan, is measured by the *Unocal* standard. Specifically, a court will ask (1) whether the board had reasonable grounds for believing a danger to corporate policy and effectiveness existed, and (2) whether the action taken (*e.g.*, adoption of a rights plan or refusal to redeem a rights plan) is reasonable in relation to the threat posed.[90]

There are numerous factors to consider when determining whether and how to adopt a rights plan, including whether the plan should be subject to shareholder approval, the duration of the plan, whether the plan should cover derivatives, whether the plan should address separate beneficial owners acting together (wolfpack behavior), and so on. Boards should also carefully consider whether any rights plan should satisfy the standards of influential proxy advisors such as ISS. There is considerable pressure from proxy advisory firms such as ISS, and from activists, for companies to adopt only those rights plans meeting certain specified criteria or to forego a plan altogether.

Responding to an activist

Know what to expect if an activist campaign is launched

According to a recent McKinsey & Company study, 73% of shareholder activist campaigns begin collaboratively, but 60% end with a public threat, proxy fight, or other hostile action.[91] Many campaigns begin with letters or verbal communications from an activist fund requesting that the company undertake some sort of strategic transaction, management change, or governance reform to "unlock what they believe is a hidden value."[92]

Activist campaigns often begin with a letter to the board criticizing a particular business segment or suggesting a proposed course of action.[93] A hedge fund could also quietly accumulate a block of shares and file a Form 13D disclosing their position, objectives, and criticisms. Activists frequently make multiple demands spanning multiple activism categories (*e.g.*, they may demand a strategic transaction as well as balance sheet or operational reforms).[94]

In many instances, activists have already reached out to other potentially sympathetic investors before they make their intentions known to management and have already developed an extensive battle plan to accomplish their objectives before lobbing their first grenade.[95] Hedge fund activists frequently "invest with a laser-focus on a price target" and "will pull as many levers as possible" to achieve that goal.[96] Activists also frequently receive support from ISS and the other proxy advisory firms, which often recommend votes in favor of asset sale proposals.

89 Holly J. Gregory, *The Elusive Promise of Reducing Shareholder Litigation through Corporate Bylaws*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (June 19, 2014, 9:25 AM), http://blogs.law.harvard.edu/corpgov/2014/06/09/the-elusive-promise-of-reducing-shareholder-litigation-through-corporate-bylaws/.

90 *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462 (Del. Ch. 2000).

91 Joseph Cyriac, Ruth De Backer, & Justin Sanders, *Preparing for Bigger, Bolder Shareholder Activists*, McKinsey & Company (Mar. 2014), http://www.mckinsey.com/insights/corporate_finance/preparing_for_bigger_bolder_shareholder_activists.

92 Doron Levit, *Soft Shareholder Activism (Oct. 2013), available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1969475.

93 *Are you Prepared for an Activist Attack?*, Fin. Profiles (Mar. 19, 2013), http://finprofiles.wordpress.com/2013/03/19/are-you-prepared-for-an-activist-attack/.

94 *See id.*

95 *Id.*

96 Tom Johnson & Pat Tucker, *Barbarians No More*, Abernathy MacGregor, http://www.abmac.com/industry-insight/barbarians-no-more/ (last visited Aug. 29, 2014).

This head start often translates into a successful outcome for the activist. For example, of the 58 high profile activist campaigns launched in 2012 that sought board representation, 45 of these activists were successful in getting their nominee elected.[97] Activists also reportedly won 67 percent of all proxy fights in 2013 and achieved settlements in numerous other cases as management increasingly sought to avoid the expense and publicity of a proxy battle.[98]

Activate activism team to assess threat

Companies can reduce the risk of becoming an activist target in the first place by proactively communicating with their shareholder base, addressing concerns by large shareholders, using stock surveillance to monitor who owns their stock, and maintaining governance and compensation practices in line with current trends.[99] Despite these precautions, no company is immune from an activist attack. Because of the head start many activists enjoy from the extensive planning that typically proceeds their opening salvo, companies must act quickly the moment an activist surfaces.

Once the potential for an activist campaign is detected, companies should immediately activate a response team to assess the situation and develop a strategy. As stated above, the team should include members of senior management, directors, investor relations personnel, financial and legal advisors (including a litigator), a public relations firm, and a proxy solicitation firm.[100] All action in addressing the activist should be coordinated through the response team.

Implement strategy for handling the activist

The response team must quickly ascertain the activist's background, ownership, and investment history, what the activist's objectives are, the level of support the activist will enjoy from other shareholders, whether other large shareholders have previously collaborated with the activist, and whether it is preferable to negotiate a resolution or to pursue a more confrontational strategy. Activists and incumbent management frequently prefer negotiating a settlement rather than engage in an expensive public fight. In many instances, companies have agreed to nominate or appoint director candidates, add board seats, make it easier for shareholders to call special meetings, separate the chairman and CEO positions, or undertake other governance reforms. Numerous companies have voluntarily eliminated staggered boards, poison pills, and other anti-takeover mechanisms in response to pressure from shareholder activists.[101]

While companies may find these types of resolutions palatable, reducing anti-takeover devices may leave companies more vulnerable to future activist attacks. The ongoing quest by Pershing Capital and Valeant to acquire Allergan, for example, has been facilitated in part by the elimination of Allergan's takeover defenses in response to previous activist campaigns.[102] Critics have argued that the elimination of staggered boards and other takeover defenses may leave companies vulnerable to lowball hostile bids and may depress value over the long haul.[103] Nonetheless, companies may face little choice given the board support activists have enjoyed in pressuring companies to eliminate these provisions.

Communication strategies

If the response team determines that a more confrontational approach is warranted, there are several paths that may be available. Because the success of an activist campaign usually depends on the support of other shareholders, management should consider reaching out to other large shareholders and offering concessions to prevent them from joining the activist.[104] It is critical that the board and senior management convey a cogent and unified message to shareholders. The company should retain a public relations firm and provide persuasive rebuttals to the activist's criticisms. In addition, management should consider attacking the activist's positions and, where appropriate, its past investment history (particularly if the activist's prior campaigns negatively affected the targets' stock price). While the proxy advisory firms are often sympathetic to the activist's position, management should also strongly consider making an effort to convince ISS and Glass Lewis to recommend the company's position.

Poison pills

The activist team should also swiftly evaluate whether the company should adopt a poison pill or modify an existing

97 *Are you Prepared for an Activist Attack?*, Fin. Profiles (Mar. 19, 2013), http://finprofiles.wordpress.com/2013/03/19/are-you-prepared-for-an-activist-attack/.
98 Tom Johnson & Pat Tucker, *Barbarians No More*, Abernathy MacGregor, http://www.abmac.com/industry-insight/barbarians-no-more/ (last visited Aug. 29, 2014).
99 *Id.*
100 Rob Swystun, *How To Prepare Your Own SWAT Team To Combat Shareholder Activism*, Pristine Advisers (Dec. 6, 2013), http://pristineadvisers.wordpress.com/2013/12/06/how-to-prepare-your-own-swat-team-to-combat-shareholder-activism/.
101 *See* Steven Davidoff Solomon, *The Case Against Staggered Boards*, N.Y. Times (Mar. 20, 2012, 12:43 PM), http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards/?_php=true&_type=blogs&_r=0.
102 Liz Hoffman, *In Allergan Case and Others, Hostile Bidders Are Making the Most of Firms' Weakened Defenses*, Wall St. J. (Aug. 25, 2014, 5:13 PM), http://online.wsj.com/articles/in-allergan-case-and-others-activist-investors-are-making-the-most-of-firms-weakened-defenses-1408998772.
103 *Id.*
104 *See* Adam Piore, *Responding to Investor Activism*, Corporate Secretary (May 8, 2013), http://www.corporatesecretary.com/articles/proxy-voting-shareholder-actions/12503/responding-investor-activism/.

pill to ward off an activist threat. As discussed above, a poison pill typically allows the company to distribute new shares to investors if an activist shareholder acquires a certain percentage (often ten percent) of the company's stock, which is the approach Safeway took in responding to an activist threat from Jana Partners.[105] Companies often adopt pills on a short-term basis in response to a perceived activist threat, as long-term pills can draw criticism from proxy advisory firms.[106]

In adopting a pill, companies should strongly consider including a "wolfpack" provision that allows the company to aggregate share accumulations by different investors who are not sufficiently entangled to trigger Rule 13(d)'s "group" reporting requirement but who are nonetheless supporting the same objectives. Companies should also consider a two-tiered pill that imposes one limit on activist investors while allowing passive investors to accumulate a larger interest before triggering the pill.[107]

The Delaware Court of Chancery recently upheld Sotheby's deployment of a two-tiered poison pill against Third Point that limited the activist to ten percent while allowing passive investors to hold up to twenty percent without triggering the pill, holding that the pill did not unduly restrict Third Point from waging its proxy battle and could be viewed as a rational and proportional response to the threat that an activist investor could obtain "creeping control" of the company without paying shareholders a control premium.[108] Third Point thereafter negotiated a settlement with Sotheby's that afforded Third Point three board seats and allowed it to increase its stake to fifteen percent, while permitting Sotheby's CEO to remain in office.[109]

Proxy contests

If the company decides to wage a proxy contest, it should be prepared for intense media and investor scrutiny of every action and comment through the shareholder meeting. Proxy contests typically involve a series of "fight letters," SEC filings, media interviews, and press releases in which the parties communicate their arguments.[110] The timeline for a typical proxy fight is 45 days, with multiple rounds of fight letters.[111] A consistent and unified message is critical throughout this time period.

Litigation options

The response team should also include an experienced litigator to consider potential legal action against the activist. While it is difficult to sue a shareholder, companies have pursued a variety of legal claims against activists. For example, companies can pursue claims under Section 13(d) of the Exchange Act if an activist (or group of activists) does not timely file a Schedule 13D that accurately discloses their holdings, investment intentions, and the identities of all group members. Courts, however, have generally been reluctant to bar activists from pursuing a proxy fight if the activist cures the omission in a supplemental Schedule 13D filing, thus limiting the effectiveness of this tactic. For 13(d) violations, an amended or supplemental 13(d) disclosure sufficiently cures any previous defects or misleading omissions and satisfies the goals of Section 13(d); courts find that the remedy of neutralization or sterilization of voting rights is not only unnecessary but also inequitable in its harm to the acquiring shareholder. *See, e.g.*, *Bender v. Jordan*, 439 F. Supp. 2d 139, 179 (D.D.C. 2006) (delaying shareholder meeting but refusing to grant a shareholder's request for neutralization of voting shares, even where shareholder met all elements for injunctive relief relating to a 13(d) violation); *Independence Fed. Savings Bank v. Bender*, 332 F. Supp. 2d 203, 217-18 (Aug. 23, 2004) (refusing to neutralize a violator's shares, a "harsh" remedy, because it would cause more harm than remedy); *E.ON AG v. Acciona, S.A.*, No. 06 Civ. 8720(DLC), 2007 WL 316874, at *10 (S.D.N.Y. Feb. 5, 2007) ("Where a corrective filing has been made, and where shareholders have had an adequate opportunity to digest that information, the need for further injunctive relief essentially ceases.").

Insider trading rules could provide another litigation avenue. Allergan recently sued Valeant and Pershing Square under Sections 14(a), 14(e), and 20A of the Exchange Act for acquiring their stock position in Allergan with inside knowledge of Valeant's planned tender offer.[112] Under SEC Rule 14e-3, if "any person has taken a substantial step or steps to commence" a tender offer, it is a violation of Section

105 Norma Cohen, *US Companies Fend Off Activists with Poison Pills*, Fin. Times (Apr. 23, 2014, 5:28 PM), http://www.ft.com/cms/s/0/b78ffe52-cada-11e3-9c6a-00144feabdc0.html#axzz3Bmr8Lc00.

106 *See* Stephen Taub, *Icahn Inspires Another Poison Pill*, Institutional Investor's Alpha (Nov. 22, 2013), http://www.institutionalinvestorsalpha.com/Article/3282045/Icahn-Inspires-Another-Poison-Pill.html.

107 *See* Gardner Davis, *Delaware's New Pill Will Give Raiders Like Dan Loeb a Headache*, Forbes (May 19, 2014, 9:29 AM), http://www.forbes.com/sites/danielfisher/2014/05/19/delawares-new-pill-will-give-raiders-like-dan-loeb-a-headache/.

108 Michael J. de la Merced & Alexandra Stevenson, *Sotheby's Poison Pill Is Upheld by Delaware Court*, N.Y. Times (May 2, 2014, 10:47 AM), http://dealbook.nytimes.com/2014/05/02/sothebys-poison-pill-is-upheld-by-court/.

109 Agustino Fontevecchia, *Truce! Dan Loeb's Third Point Gets 3 Board Seats, But Sotheby's CEO Bill Ruprecht Stays on Board*, Forbes (May 5, 2014, 12:49 PM), http://www.forbes.com/sites/afontevecchia/2014/05/05/truce-dan-loebs-third-point-gets-3-board-seats-but-sothebys-ceo-bill-ruprecht-stays-on-board/.

110 Rachel Posner, *Anatomy of a Proxy Fight*, The Corporate Board (July/Aug. 2014), http://www.amstock.com/new/news/news070114.pdf.

111 *Id.*

112 *See Allergan, Inc. v. Valeant Pharms. Int'l, Inc.*, Case No. 8:14-cv-01214-DOC-AN (C.D. Cal. Aug. 1, 2014).

14(e) "for any other person who is in possession of material [nonpublic] information relating to such tender offer" to purchase or sell securities of the target company. Allergan alleged that Pershing Square and Valeant were separate "persons" for purposes of Rule 14e-3, and that Pershing Square thus illegally acquired its position in Allergan because it was aware of Valeant's tender offer plan before it acquired shares. The court recently denied Allergan's motion to expedite the case. Meanwhile, the Delaware Court of Chancery has set an October 6 trial date on Valeant's suit to force a special meeting, which could occur as early as mid-November.[113]

Companies are occasionally able to exclude proxy proposals by shareholders who fail to comply with SEC rules. Several companies have successfully sued activist John Chevedden (a smaller-stake shareholder who focuses primarily on governance issues) to exclude proxy proposals. In *KBR v. Chevedden*,[114] for example, the Fifth Circuit affirmed a declaratory judgment allowing a company to exclude a Chevedden proposal based on Chevedden's failure to document his stock ownership or otherwise demonstrate his eligibility under SEC Rule 14a-8.[115] After Chevedden repeatedly refused to withdraw his request or confirm his eligibility, KBR obtained a declaratory judgment that it could exclude his proposal.[116] The Fifth Circuit rejected Chevedden's argument that there was no private right of action under Section 14 of the Securities Exchange Act, noting that the Supreme Court specifically recognized a private right of action under Section 14(a) to enforce proxy regulations.[117] The Fifth Circuit also held that the proposal dispute was an "actual controversy" that impacted KBR's duties to other shareholders and was therefore a proper subject of declaratory relief.[118] More recently, however, Chevedden defeated two other declaratory suits by promising not to sue the company if his proposal was excluded (thus depriving the court of an "actual or imminent" controversy that would warrant declaratory relief).[119] The tactic of suing activists to exclude shareholder proposals is also less likely to be availing against larger activists with more sophisticated legal counsel who are less likely to run afoul of SEC rules for submitting proxy proposals.

Targets may also be able to use the Hart-Scott-Rodino Antitrust Improvement Act of 1976 (the "HSR Act") as a weapon against activists. In 2012, Bilgari Holdings paid $850,000 to settle a Federal Trade Commission complaint that it violated premerger notification requirements by falsely disclosing a "passive" investment in Cracker Barrel Old Country Store, Inc. when in fact it was an activist investor that intended to become actively involved with management.[120] The HSR Act imposes waiting periods on transactions exceeding a certain threshold, but provides an exemption for passive investments of up to ten percent of voting securities if the acquisition is made solely for the purpose of investment.[121] If, however, the investor intends to become actively involved in the management of the company, the exemption does not apply.[122] Companies may consider alerting regulators if an activist shareholder has not complied with the HSR Act.

Other federal and state law provisions can also provide fodder for companies seeking to fend off an activist. For example, an activist that has acquired more than ten percent of an issuer's equity may be deemed an "insider" under Section 16(b) of the Exchange Act and may be required to disgorge any profits from purchases and sales within a six-month period. Activist investors may also run afoul of state anti-takeover statutes, which hinder the ability of hostile acquirers to take control.[123]

Conclusion

In short, there are a number of options for preparing for and responding to an activist attack. These options should all be carefully considered with internal and external advisors in the context of the company's long-term plans.

Legislative developments

In the coming years, we may see legislation and rule making that effects the landscape of shareholder activism. Two potential developments are changes to the 13D filing requirements and increased regulation of the proxy advisory firms.

113 Matt Chiappardi, *Chancery Fast-Tracks Ackman Suit to Force Allergan Meeting*, Law360 (Aug. 27, 2014, 2:51 PM), https://www.law360.com/articles/571420.
114 No. 11-20921, 2012 WL 2094081 (5th Cir. June 11, 2012).
115 *Id.* at *1 (citing 17 C.F.R. § 240.14a-8(b)(2), which requires that shareholders have investments totaling "at least $2,000 in market value, or 1% of the company's [voting] securities" to be eligible to submit a proxy proposal).
116 2012 WL 2094081 at *1.
117 *Id.* at *2 (citing *J.I. Case Co. v. Borak*, 377 U.S. 426, 431-33 (1964)).
118 2012 WL 2094081 at *2.
119 *Shareholder Proposals: Chevedden Wins Two Lawsuits*, The Corporate Counsel (Mar. 13, 2014), http://www.thecorporatecounsel.net/blog/2014/03/shareholder-proposals-chevedden-wins-two-lawsuits.html.
120 *Biglari Holdings, Inc. to Pay $850,000 Penalty to Resolve FTC Allegations that it Violated U.S. Premerger Notification Requirements*, F.T.C. (Sept. 25, 2012), http://www.ftc.gov/news-events/press-releases/2012/09/biglari-holdings-inc-pay-850000-penalty-resolve-ftc-allegations.
121 *Id.*
122 *Id.*
123 *See* Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, J. of Empirical Legal Stud. (June 2009), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1554&context=fss_papers. (describing state anti-takeover statutes).

13D filing requirements

Section 13(d) of the Exchange Act was enacted as part of the Williams Act to give the markets early warning of stock acquisitions that could be the first step in a plan to acquire control of the target company. As noted below, however, some have argued that the current rules should be modernized in light of current technology.

10-Day filing period

Technological advances have led many to question whether the intended purpose of Section 13(d) is still being served by 13D's 10-day filing window. The traditional timelines for the acquisition of shares that applied in 1968 are relics of the past. Today, in the world of computerized trading, a massive number of shares can be accumulated in a matter of seconds. And, once the 5% threshold has been reached, additional shares can be purchased until the 13D window closes. This lag between crossing the 5% ownership threshold and the reported deadline gives activist investors, whose number one priority is discretion when building a position, a powerful tool.

Since 2010 with the passage of Dodd Frank, the SEC has had the authority to address these concerns and shorten the 10-day reporting deadline.[124] In other contexts, the SEC has recognized that its reporting regimes should take into account the advances in market technology by shortening the timelines for filings. For example, in 2004, the SEC reduced the deadline for filing a Current Report on Form 8-K to 4 business days after the reportable event.[125] In addition, Regulation F-D requires issuers to inform the market of any material, non-public information simultaneously with its intentional disclosure to any outside party.[126]

Shorter timeframes are currently in place in a number of jurisdictions outside the United States. The United Kingdom imposes a 2 trading day deadline for disclosure of acquisitions in excess of 3 percent of an issuer's securities. Germany requires a report "immediately" but in no event later than 4 days after crossing the acquisition threshold. Hong Kong requires a report within 3 business days of the acquisition of a "notifiable interest" under the law.

In March 2011, Wachtell, Lipton, Rosen & Katz Lipton filed a petition for rulemaking under Section 13 of the Exchange Act with the SEC. Wachtell's submission requested that the SEC "clos[e] the Schedule 13D ten-day window between crossing the 5 percent disclosure threshold and the initial filing deadline, and adopt a broadened definition of 'beneficial ownership' to fully encompass alternative ownership mechanisms."[127] Wachtell recommended changing the reporting deadline from 10 days to 1 business day.

Many commentators agree with the Wachtell position. The fear is that if the SEC fails to modernize the reporting deadline, activist investors with short-term perspectives will gain an unfair advantage to the detriment of long-term investors. Under the current regime, investors can acquire just under 5% of a company's shares, make all their preparations for additional purchases, and then cross the threshold and acquire a large amount of additional shares before 10 days passes and public disclosure is required. Shortening the filing deadline diminishes the surprise element and would give the target company's management additional time to prepare a response or defense.

On the other side of the debate are hedge funds and academics such as Lucian Bebchuk (Harvard Law School) and Robert Jackson (Columbia Law School). During a July 2011 meeting with the SEC, Roy Katzovicz of Pershing Square Capital Management and others presented materials prepared by Members of the Managed Funds Association that claim a revised 13D filing regime "[c]ould chill activity which helps give life to shareholder democracy and addresses classic principal-agent issues."[128] Bebchuk and Jackson challenge the need for change on empirical grounds claiming that there is no evidence to suggest that investors can now acquire large blocks of stock more quickly than they could when Section 13(d) was first enacted in 1968. Perhaps more importantly, they claim that tightening the 10-day filing period would actually harm investors and undermine efficiency because the accumulation and holding of outside blocks make incumbent directors and managers more accountable.[129]

124 Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC has new statutory authority to shorten the 10-day filing period for Schedule 13D filings and to regulate beneficial ownership reporting of security-based swaps. Congress modified §13(d)(1) of the Exchange Act to read: "within ten days after such acquisition, *or within such shorter time as the Commission may establish by rule.*" Dodd-Frank Wall Street Reform and Consumer Protection Act § 929R (emphasis added).

125 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release Nos. 33-8400, 34-49424; File No. S7-22-02 (Mar. 16, 2004), *available at* http://www.sec.gov/rules/final/33-8400.htm.

126 Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, IC-24599; File No. S7-31-99 (Aug. 15, 2000) (adopting Regulation FD), *available at* http://www.sec.gov/rules/final/33-7881.htm.

127 Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, Mar. 7, 2011, *available at* http://www.sec.gov/rules/petitions/2011/petn4-624.pdf.

128 *See, e.g.*, Memorandum from Scott H. Kimpel of the Office of Commissioner Troy A. Paredes of the Securities and Exchange Commission Regarding Request for Rulemaking Regarding the Beneficial Ownership Reporting Rules Under Section 13 of the Securities Exchange Act of 1934 (July 20, 2011), File No. 4-624, *available at* http://www.sec.gov/comments/4-624/4624-4.pdf.

129 Lucian Bebchuk, *Should the SEC Tighten its 13(d) Rules?*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (June 27, 2012, 9:43 AM), http://blogs.law.harvard.edu/corpgov/2012/06/27/should-the-sec-tighten-its-13d-rules/.

In December 2011, the SEC publicly spoke on the subject, but rather than give any signal of which way the SEC was leaning, summarized what it viewed as the primary arguments on both sides of the debate.[130] SEC Chairwoman Schapiro noted that many feel that the 10-day reporting deadline "[r]esults in secret accumulation of securities; [r]esults in material information being reported to the marketplace in an untimely fashion; and [a]llows 13D filers to trade ahead of market-moving information and maximize profit, perhaps at the expense of uninformed security holders and derivative counterparties."[131] Schapiro also outlined arguments against a revised Schedule 13D, including the arguments that "[t]ightening the timeframe may reduce the rate of returns to large shareholders, and thereby result in decreased investments and monitoring of and engagement with management; [t]here is no evidence that changes in trading technologies and practices have led to significant increases in pre-disclosure accumulations of large ownership stakes; and [s]tate law developments, such as the validity of poison pills, staggered boards and control share statutes, have tilted the regulatory balance in issuers' favor."[132]

As of the date of this writing, the SEC has not yet taken a position with respect to the 13D reporting deadlines. However, the Pershing Square-Valeant bid for Allergan may put some pressure on the SEC to take action. Prior to the filing of the complaint, writing in a post on the Harvard Law Forum on Corporate Governance and Financial Regulation, Wachtell repeated its call to change the "SEC's outdated 'early-warning' rules" citing the Pershing Square-Valeant bid as a "crafty" example of market abuse. The Wachtell posting called for SEC action with urgency claiming that "[t]his new stratagem emphasizes the crying need for the SEC to bring its early-warning rules into the 21st century, as we have been urging for several years. The SEC should forthwith move to close the 10-day filing window and the wide loophole opened by ever-more-complex derivative trading schemes."[133]

The Allergan complaint criticized the existing rules as well. According to the complaint, Pershing Square's shell entity, PS Fund 1, acquired 9.7% of Allergan's outstanding stock before making any disclosure and accuses the bidders of engaging in a "rapid buying spree, in order to exploit the Williams Act's archaic ten-day window, an oft-criticized provision that allows an investor to wait ten full days after crossing the 5% threshold before disclosing its acquisitions and intentions to the market." [134]

Beneficial ownership reporting rules

In addition to the 10-day filing period, many commentators take issue with 13D's rules applicability (or non-applicability) to non-traditional investments. Modern investors structure transactions differently than they did in 1968. Non-traditional cash-settled derivatives are common and there is a noticeable trend of investors obtaining influence or control over voting and disposition of large blocks, while a third party technically holds those rights. These non-traditional investments typically do not count toward the beneficial ownership threshold except when they confer upon their holder the right to acquire beneficial ownership over the underlying security within sixty days.[135] As a result, many have said that "the current definition of beneficial ownership does not account for the realities of how derivatives and other synthetic instruments and ownership strategies are used today in complex trading strategies" and have called for change.[136]

Schapiro announced that the SEC plans a broad review of the beneficial ownership reporting rules stating "[w]e think it's important to modernize our rules, and we are considering whether they should be changed in light of modern investment strategies and innovative financial products."[137] But, to date, that review has not occurred.

Clarify definition of group

Finally, some have called on the SEC to clarify the definition of "group."[138] This request has come as investors have worked in connection with one another without individually acquiring a 5% beneficial ownership interest. These shareholders are therefore working on the fringes of Rule 13(d), in some cases have not been required to file 13Ds, and some would argue are subverting the purpose of the rule. Therefore, commentators have asked the SEC to weigh in.[139]

130 Chairwoman Mary L. Schapiro, Remarks at the Transatlantic Corporate Governance Dialogue, U.S. Securities and Exchange Commission (Dec. 15, 2011), *available at* http://www.sec.gov/news/speech/2011/spch121511mls.htm.
131 *Id.*
132 *Id.*
133 Trevor Norwitz, *A New Takeover Threat: Symbiotic Activism*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (Apr. 25, 2014, 4:45 PM), http://blogs.law.harvard.edu/corpgov/2014/04/25/a-new-takeover-threat-symbiotic-activism/
134 *See Allergan, Inc. v. Valeant Pharm. Int'l, Inc.*, Case No. 8:14-cv-01214 (C.D. Cal. Aug. 1, 2014).
135 17 C.F.R. § 240.13d-3(a).
136 Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934 (Mar. 7, 2011), *available at* http://www.sec.gov/rules/petitions/2011/petn4-624.pdf.
137 Chairwoman Mary L. Schapiro, Remarks at the Transatlantic Corporate Governance Dialogue, U.S. Securities and Exchange Commission (Dec. 15, 2011), *available at* http://www.sec.gov/news/speech/2011/spch121511mls.htm.
138 Andrew Nagel et al., *The Williams Act: A Truly "Modern" Assessment*, Harv. Law Sch. Forum on Corp. Governance & Fin. Regulation (Oct. 22, 2011, 9:49 AM), http://blogs.law.harvard.edu/corpgov/2011/10/22/the-williams-act-a-truly-%E2%80%9Cmodern%E2%80%9D-assessment/.
139 *Id.*

Rules related to proxy advisory firms

Proxy advisory firms play a large role in shareholder activism campaigns. This is because they make recommendations on shareholder proposals that some institutional investors are bound to follow. Proxy advisory firms are currently subject to less rigorous oversight than traditional investment advisors. Given this lack of oversight, concerns have manifested about conflicts of interest among other things.[140]

Industry actors and the US Chamber of Commerce have urged the SEC to increase its oversight of proxy advisory firms.[141] And the Commission has taken steps to do so. For example, in December 2013, the SEC hosted a roundtable to discuss the role that proxy advisors play in modern capital markets and to debate the possibility to issue rules or guidance to govern these firms.[142] Based on this roundtable and a follow-on SEC plan of action, the SEC intends to hand down new guidelines for proxy advisory firms in the near future.

Conclusion

Shareholder activism is a trend that is here to stay. Although new regulation may enter the space, it will not obviate the need for management to prepare for and respond to activist campaigns. In the end, a well thought-out strategy will be beneficial to all of the company's shareholders, including the activists.

140 David Gelles, *Lively Debate on the Influence of Proxy Advisory Firms*, N.Y. Times (Dec. 5, 2013, 8:22 PM), http://dealbook.nytimes.com/2013/12/05/lively-debate-on-the-influence-of-proxy-advisory-firms/?_php=true&_type=blogs&_r=0.

141 Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation* (July 21, 2014).

142 Proxy Advisory Services Roundtable, U.S. Securities and Exchange Commission, http://www.sec.gov/spotlight/proxy-advisory-services.shtml (last visited Aug. 27, 2014).

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