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Corporate Governance

Dealing with activist hedge funds and 'hushmail'

By John Newell, Bradley Faris, Timothy Fitzsimons and Mark Gerstein

Increasingly, some activist hedge funds are looking to sell their stock positions back to target companies. The recent explosion of activist investing by hedge funds has brought about a new phenomenon, which can be referred to as "hushmail." Every board should understand a few things before agreeing to pay hushmail to an activist.

What's hushmail?

Activist hedge funds often take large stock positions in a target company, and then publicly agitate for changes, such as stock repurchases, extraordinary dividends, dispositions of non-core businesses or an outright sale of the company. There is often an implicit or explicit threat of a proxy contest to remove some or all of the target board members and management if the activist's demands are not met. Ultimately, the activist may receive one or more seats on the target company board, either through a settlement with the target, or success at a stockholder meeting.

Eventually, the hedge fund may seek to dispose of its position in the stock. In order to exit quickly at the highest possible price, the activist sometimes seeks to persuade the target company to buy back its stock rather than dumping the shares in the market. In the 12 months prior to June 30, 2014, nine companies had repurchased shares from activists, which is more than the previous six years combined, according to data from FactSet SharkWatch.

The buyback price is typically at a slight discount to the current market price, but occasionally it is at a premium. As part of the purchase agreement, the activist may offer a standstill and nondisparagement agreement with the target. Payment to an activist under these circumstances is referred to as hushmail.

What are the dangers?

Any stock buyback must be undertaken carefully, after the board appropriately reviews a number of important factors. If a board approves a repurchase of stock from an activist investor, the board may face criticism from stockholders on the grounds that the opportunity to sell is not made available to all stockholders. Stockholders may also complain that the stock repurchase is motivated by management entrenchment, and the repurchase price is excessively high and therefore unfair to the company or its other stockholders.

How should a company decide whether to pay?

Payment of hushmail may be in the best interest of the target stockholders. It is well established that a Delaware corporation has the power to deal in its own stock and that the corporation may deal selectively with its stockholders in the acquisition of shares. The Delaware courts have long acknowledged a variety of sound reasons why a board may agree to buy back its shares from a dissident stockholder, even at a premium to the current market price.

The Delaware Supreme Court has held that, if a stock buyback is not made in response to an actual or potential threat to corporate policy, then, "in the absence of evidence of fraud or unfairness, a corporation's repurchase of its capital stock at a premium over market from a dissident stockholder is entitled to the protection of the business judgment rule." See *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988);

The board should carefully consider and document the reasons for entering into the transaction in order to create an effective record of its rationale for approving the buyback. A board can help establish that it acted in good faith and made a reasonable investigation if that board is composed of a majority of outside directors, and advised by expert legal and financial advisors.

When should a board approve payment?

To execute a favorable financial transaction: If a buyback makes economic financial sense to the board, the board may determine that a repurchase of a block from a large stockholder who is eager to sell is a more efficient method to execute the repurchase than buying shares in the market. In that regard, if the company has an existing stock buyback program in place, the program may provide additional support for the board's position that the repurchase from the activist achieves financial rather than defensive objectives.

To remove a disruptive shareholder: Another reason to buy back shares from a dissident stockholder could be that the stockholder is a source of controversy or friction with consequences adverse to the interests of the company and its stockholders generally, so the board wishes to buy out the stockholder to remove the source of the dispute.

As a defense against a threat to corporate policy and effectiveness: In some cases, activist hedge funds may present an actual or potential threat to corporate policy and effectiveness. There may also be a concern about management and board entrenchment if the activist is threatening a proxy contest. A buyout of the activist's shares may be considered a defensive action by the board in response to the threat, which could trigger a heightened standard of judicial review of the board's actions.

Activists can pose several threats. For example, the activist may attempt to gain control of the target without paying an appropriate value. Activist hedge funds often acquire large stock ownership positions through open market purchases, sometimes without adequate disclosure of their purchases and intentions. This could present a risk of "creeping control," in which effective control is acquired by the hedge fund without payment of a control premium to the other stockholders.

There can also be a threat of "negative control," in which the hedge fund can effectively block corporate actions through voting power and other influence. Activists and other hedge funds also sometimes work collectively to acquire stock by means of "wolf pack" tactics, which can also present further threats of creeping control and negative control.

The repurchase of stock from an activist hedge fund, even at a premium, in response to a threat of creeping control or negative control does not coerce the other stockholders in any way, nor does it preclude a proxy context by another stockholder. The other stockholders of the target are free to mount their own proxy contest and are free to vote their shares as they choose.

In addition to buying back the activist's stock, the target company may also require that the activist enter into standstill and nondisparagement covenants. If the perceived threat is creeping control by the hedge fund, or negative control, then covenants preventing the activist from acquiring additional shares, or working alone or with other stockholders to influence control of the target through public criticism, should be considered as reasonable responses.

What other options does a board have?

In the 1980s, some companies adopted charter or bylaw amendments prohibiting the payment of "greenmail" — payments made by a target company to a corporate raider in order to ward off a takeover bid, which were common at the time. If hushmailing continues its rise, companies may consider adopting similar provisions to address it, such as requiring disinterested stockholder approval of a stock repurchase. Institutional investors are likely to support these changes, which should alleviate concerns about hushmail being paid for entrenchment purposes, as well as concerns that activist stockholders are getting special treatment not available to other stockholders.

By declaring that a hushmail payment is not an option, activist hedge funds seeking a quick payoff may look elsewhere for a more vulnerable target. At the same time, these changes may reduce a board's flexibility to respond to hushmail demands and, in that sense, may reduce the utility and benefits of this strategy.

John Newell *is a partner in Latham & Watkins LLP's San Francisco office.* **Bradley Faris, Timothy Fitzsimons** and **Mark Gerstein** *are partners in Latham's Chicago office.*