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# Is Activism Moving In-House

Martin Lipton

In large measure, institutional investors, particularly the passive indexers, have outsourced oversight of their portfolios to ISS and Glass Lewis and for much of the past decade to activist hedge funds. The result has been enormous profits for activist hedge funds that have attracted investments of more than $200 billion and are now considered an asset class for investment purposes. Concomitantly, in order to lower their profile to activists trolling for targets, virtually every public company has followed the advice to "manage like an activist" and reduced capital expenditures, research and development, employee training and employment. Activism has become a very significant drag on the economy and a threat to the long-term health of the Nation.

Lately several of the major institutions have recognized that while an activist attack on a company might produce an **increase** in the market price of one portfolio investment, the defensive reaction of the other hundreds or thousands of companies in the portfolio, that have been advised to "manage like an activist", has the potential of lower market prices for a large percentage of those companies and a net large **decrease** in the total value of the portfolio over the long term. Laurence Fink, CEO of BlackRock, the world's largest money manager, in a recent letter to S&P 500 CEOs said, "More and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth." Similarly, in a recent speech William McNabb, CEO of Vanguard said, "And, remember, when it comes to our indexed offerings, we are permanent shareholders. To borrow a phrase from Warren Buffet: "Our favorite holding period is forever. We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits. In other words, we're big, we don't make a lot of noise, and we're focused on the long term. That is *precisely* why we care so much about good governance. Vanguard funds hold companies in perpetuity. We want to see our investments grow over the long-term. We're not interested in managing the companies that we invest in. But we do want to provide oversight and input to the board of directors. And we count on boards to oversee management."

BlackRock and Vanguard and a number of other major institutions are saying that their support for the long-term plans of a company and their support of its management against activist attacks are conditioned on satisfaction, (1) that the long-term plans have been carefully considered and are understood by the directors, (2) with the company's corporate governance, (3) with the expertise and independence of the directors, (4) with their ability to engage directly with the directors, (5) with frequency and quality of regular evaluation of the performance of the directors and (6) that compensation is tied to performance and total shareholder return. See the attached memo, "Some Lessons from BlackRock, Vanguard and DuPont—A New Paradigm for Governance".

Essentially, DuPont's defeat of Trian Partners' proxy fight to replace four DuPont directors reflects these conditions and is being viewed as confirmation that a well-managed corporation executing a clearly articulated business strategy will have institutional investor support and can prevail against an activist, even when the major proxy advisory services (ISS and Glass Lewis) support the activist. The following lessons from the DuPont-Trian proxy fight, together with the recently announced policies of institutional investors to support the well-conceived business plans of companies that meet their governance standards, indicate a new paradigm for portfolio oversight by these institutions.

*Challenges of a Proxy Fight with an Activist.* Each proxy contest is unique. For many companies, the risks and potential harm from a public proxy contest may lead the company to consider a negotiated resolution, especially when faced with the likely support of the activist by the proxy advisory services. The issues, tactics, team and approaches to an activist challenge will vary depending on the company, the industry, the activist and the substantive business and governance issues at play, among other factors. For those companies that decide a negotiated resolution is not warranted, or is not achievable on acceptable terms, the ability to wage an effective campaign will depend on advance preparation and actions as outlined in the attached memo, "Dealing with Activist Hedge Funds". The fact that DuPont, a leading American company with a distinguished board and management, a strong track record and a long history of world-class innovation won only by a close vote after a long fight in the face of contrary recommendations from the major proxy advisory services underscores the challenges faced by all companies dealing with activists in the current environment and the critical importance of having the support of the investors who have embraced the new paradigm. Below are the other key takeaways from DuPont-Trian.

*Substantive Business Change.* DuPont's own value-creating initiatives proved to be a central pillar of its successful defense. Instead of letting Trian define DuPont as defending the status quo, the company demonstrated active management of its business portfolio, accelerated its cost-cutting plans, articulated a disciplined approach to research and development investment, increased return of capital through dividends and share buybacks, and made other productivity and business enhancements. As CEO Ellen Kullman argued, "We have been agents of change. We have restructured. . . . we've got momentum. We are transforming." While Trian sought to take credit for these steps, in reality the company's own board and management was able to show that DuPont moved decisively to execute business and strategic initiatives.

*Board Refreshment and Director Involvement.* DuPont effectively wielded board change as an offensive tactic, adding two new "super star" directors with relevant expertise (Edward Breen and James Gallogly) to its distinguished board. In addition, the independent directors, alongside the CEO and senior management, tirelessly advocated personally for their vision of DuPont, explained why they had earned—and deserved—the trust and confidence of shareholders and why supporting Trian would result in losing valuable expertise on the board. In large measure the vote can be viewed as an endorsement by the shareholders of CEO Ellen Kullman and the DuPont board as more likely to successfully lead the company than Nelson Peltz and the Trian nominees.

*Tying the Campaign to Broader Themes and Securing Influential Third-Party Support.* DuPont successfully argued that the excesses of shareholder activism contribute to short-term pressures that undermine economic growth, real innovation and sustained employment, and hinder prudent reinvestment of corporate profits into research and development and other value-creating initiatives. Harvard Professor William George's article, "The DuPont Proxy Contest Is a Battle for the Soul of American Capitalism" made the stakes clear.

*Finding Stockholder Champions*. Through close and effective engagement, DuPont secured the public, pre-vote support of respected and influential stockholders such as CalPERs and the Canada Pension Plan Investment Board. Anne Simpson, CalPERs' Director of Corporate Governance and Senior Portfolio Manager, Investments, went on record criticizing the activist's thesis as "relatively short term" and expressing concern about "cost cutting which would reduce research and development."

*Communicating Effectively with Institutional Investors and Governance and Voting Professionals.* DuPont took its case directly to the traditionally "passive" investors and to governance and voting professionals. In doing so, DuPont's executives and independent directors emphasized the unique needs of a global science company in the midst of strategic transformation and proof of outperformance, as well as DuPont's good governance and board practices, effective oversight by independent directors, proven commitment to long-term value creation, aligned executive compensation, and its sustainability and corporate citizenship initiatives.

*Communication Tools and Media.* Messaging by DuPont included a dedicated campaign website, videos from the CEO and the Lead Director, targeted advertisements, effective use of national, local, and industry press, tailored proxy materials and investor presentations and CEO participation in interviews and magazine profiles with leading publications.

*Setting the Record Straight.* In the face of frequent "white papers" and aggressive critiques from Trian, DuPont responded comprehensively and in real-time using a variety of methods. These included timely infographics, rebuttals, presentations and letters that presented objective evidence of the company's strong performance and exposed misleading and incomplete claims and analyses by Trian. DuPont also cultivated sell-side analysts effectively.

*Engaging with the Activist and Carefully Considering its Ideas.* Nearly two years of engagement between DuPont and Trian enabled the company to fully evaluate the activist's proposals. It also allowed DuPont to demonstrate that it was genuinely open to engagement (including settlement possibilities) and to considering new ideas. But once the board concluded that at least some of the recommendations were ill-advised and that fundamental disagreements on business strategy made a settlement on the terms sought by the activist unacceptable, the company relentlessly made its case for why it would not adopt what it considered a "value-destructive, high-risk" agenda to "break up DuPont, burden it with excessive debt and destroy value."

*Targeting the Retail Vote.* The very high percentage (over 30%) of shares held by retail shareholders, including some former employees, made retail vote turnout a top priority; DuPont used a variety of creative methods to reach this constituency.

*Maintaining Employee Morale and Staying Focused on the Business.* Every constituency matters in a proxy contest, and DuPont went to great efforts to preserve the focus and loyalty of its employees using employee-specific messaging and other methods. In addition, DuPont worked hard to minimize the distraction of a proxy fight and to preserve management's focus on business execution.

*Investing in Innovation.* Activist attacks against research and development and other capital expenditures targeted at innovation have increased. Effectively explaining why research and development matters and why a company's board and management can be trusted to be thoughtful and objective regarding research and development-focused investment remains critical for science and technology companies.

Another part of BlackRock CEO Laurence Fink's message is worth keeping in mind: "It is critical, however, to understand that corporate leaders' duty of care and loyalty is not to every investor or trader who owns their companies' shares at any moment in time, but to the company and its long-term owners. Successfully fulfilling that duty requires that corporate leaders engage with a company's long-term providers of capital; that they resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, that they clearly and effectively articulate their strategy for sustainable long-term growth. Corporate leaders and their companies who follow this model can expect our support."

As activism moves in-house and the new paradigm becomes pervasive, the influence of the hedge fund activists and ISS and Glass Lewis will shrink. It will be replaced by the policies, evaluations and decisions of the major institutions. While this will be a welcome relief from the short-termism imposed by the hedge fund activists, it raises a new fundamental question—how will the institutions use their power? In an article in "Fortune" discussing the ramifications of the outcome of the DuPont-Trian proxy fight, Ram Charan posed the cogent question: "As the biggest asset managers gain more power and exercise it more freely, they bear a heavy responsibility. They may influence employment, national competiveness, and economic policy for better or for worse. They can ensure a balance between short-term and long-term corporate goals, and between value creation and societal needs. They can keep succession planning near the top of every company's agenda. How they will discharge their responsibility remains to be seen, but we know that the Fortune 500 have entered a new era." I'm more comfortable that the influence of the major institutions will be more favorable to the Nation's economy and society than the self-seeking personal greed of the hedge fund activists.

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Some Lessons from BlackRock, Vanguard and DuPont—A New Paradigm for Governance

Recent statements by the CEOs of BlackRock and Vanguard rejecting activism and supporting investment for long-term value creation and their support of DuPont in its proxy fight with Trian, prompt the thought that activism is moving in-house at these and other major investors and a new paradigm for corporate governance and portfolio oversight is emerging.

An instructive statement by the investors is that they view a company's directors as their agents; that they want to know the directors and have access to the directors; that they want their opinions heard; and that their relations with the company and their support for its management and board will depend on appropriate discussion of, and response to, their opinions.

The investors want to engage with the directors on a regular basis. They suggest that the company have a program or process for regular engagement. One suggestion is a shareholder relations committee of the board. Other suggestions range from directors accompanying management on investor visits; to directors attending investor day programs and being available to the investors; to the lead director being the liaison for communication. The investors are not wedded to any one form of engagement and are content to leave that to the company and its board.

The investors want independent oversight by a balanced board of effective directors that has appropriate skill sets to properly discharge its responsibilities. They expect the board to arrange meaningful evaluations of its performance and to regularly refresh its membership. They expect "best practices" corporate governance and compensation keyed to performance and shareholder returns.

The investors want the company to proactively communicate its business strategy to its shareholders, and to keep them advised of developments and problems. Vanguard suggests that directors think like activists "in the best sense" and question management's blind spots and the board's own blind spots. To aid in that effort, Vanguard suggests that the board bring in a sell-side analyst who has a sell recommendation. The investors will not accept that there is insufficient time for engagement and discussion of the business or that SEC Reg FD forecloses meaningful discussion.

The investors expect the company to hear out an activist hedge fund that takes a meaningful position in its shares. But Vanguard says, "It doesn't mean that the board should capitulate to things that aren't in the company's long-term interest. Boards must take a principled stand to do the right thing for the long-term and not acquiesce to short-term demands simply to make them go away."

As activism moves in-house at major investors and the new paradigm becomes pervasive, the influence of the activist hedge funds and ISS and Glass-Lewis will shrink and will be replaced by the policies, evaluations and decisions of the major investors. While this will be a welcome relief from the short-termism imposed by the activist hedge funds, it raises a new fundamental question—how will investors use their power? This remains to be seen. It is not likely that activism and short-termism will totally disappear, but I'm comfortable that the influence of major investors will be more favorable to shareholders generally and to the Nation's economy and society, than the self-seeking personal greed of hedge fund activists.

Martin Lipton

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# Dealing with Activist Hedge Funds

Today, regardless of industry, no company can consider itself immune from hedge fund activism. Indeed, no company is too large, too popular or too successful, and even companies that are respected industry leaders and have outperformed the market and peers have come under fire. Among the major companies that have been targeted are Amgen, Apple, Microsoft, Sony, General Motors, Qualcomm, Hess, P&G, eBay, Transocean, ITW, DuPont, and PepsiCo. There are more than 100 hedge funds that have engaged in activism. Activist hedge funds are estimated to have over $200 billion of assets under management, and have become an "asset class" that continues to attract investment from major traditional institutional investors. The additional capital and relationships between activists and institutional investors encourages increasingly aggressive activist attacks.

The major activist hedge funds are very experienced and sophisticated with professional analysts, traders, bankers and senior partners that rival the leading investment banks. They produce detailed analyses ("white papers") of a target's management, operations, capital structure and strategy designed to show that the changes they propose would quickly boost shareholder value. These white papers may also contain aggressive critiques of past decisions made by the target and any of the target's corporate governance practices that are not current "best practices". Some activist attacks are designed to facilitate a takeover or to force a sale of the target. Prominent institutional investors and strategic acquirors have been working with activists both behind the scenes and by partnering in sponsoring an activist attack such as CalSTRS with Relational in attacking Timken, Ontario Teachers' Pension Fund with Pershing Square in attacking Canadian Pacific, and Valeant partnering with Pershing Square to force a takeover of Allergan.

Many major activist attacks involve a network of activist investors ("wolf pack") which supports the lead activist hedge fund, but attempts to avoid the disclosure and other laws and regulations that would hinder or prevent the attack if they were, or were deemed to be, a "group" that is acting in concert. Not infrequently, at the fringe of the wolf pack are some of the leading institutional investors, not actively joining in the attack, but letting the leader of the pack know that it can count on them in a proxy fight. The outcome of a proxy contest at most of the larger public companies is often, as a practical matter, determined by the votes of the three major passive investors: BlackRock, State Street and Vanguard. Major investment banks, law firms, proxy solicitors, and public relations advisors are now representing activist hedge funds and eagerly soliciting their business.

Among the attack devices used by activists are:

(a) aggressively criticizing a company's announced initiatives and strategy and presenting the activist's own recommendations and business plan;

(b) proposing a precatory proxy resolution for specific actions prescribed by the activist or the creation of a special committee of independent directors to undertake a strategic review for the purpose of "maximizing shareholder value";

(c) conducting a proxy fight to get board representation at an annual or special meeting or through action by written consent (solicitation for a short slate is very often supported by ISS and, if supported, is often successful, in whole or in part);

(d) orchestrating a "withhold the vote" campaign;

(e) seeking to force a sale by leaking or initiating rumors of an unsolicited approach, publicly calling for a sale, acting as an (unauthorized) intermediary with strategic acquirers and private equity funds, making their own "stalking horse" bid or partnering with a hostile acquirer to build secret substantial stock positions in the target to facilitate a takeover;

(f) rallying institutional investors and sell-side research analysts to support the activist's arguments;

(g) using stock loans, options, derivatives and other devices to increase voting power beyond the activist's economic equity investment;

(h) using sophisticated public relations, social media and traditional media campaigns to advance the activist's arguments;

(i) hiring private investigators to establish dossiers on directors, management and key employees and otherwise conducting aggressive "diligence"; and

(j) litigation.

SEC rules do not prevent an activist from secretly accumulating a more than 5% position before being required to make public disclosure and do not prevent activists and institutional investors from privately communicating and cooperating.

Prevention of, or response to, an activist attack is an art, not a science. There is no substitute for preparation. To forestall an attack, a company should regularly review its business portfolio and strategy and its governance and executive compensation issues. In addition to a program of advance engagement with investors, it is essential to be able to mount a defense quickly and to be flexible in responding to changing tactics.

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

This outline provides a checklist of matters **to be considered** in putting a company in the best possible position to prevent or respond to hedge fund activism.

## Advance Preparation

Create Team to Deal with Hedge Fund Activism:

- A small group of key officers plus legal counsel, investment banker, proxy soliciting firm, and public relations firm.
- Continuing contact and periodic meetings of the team are important.
- A periodic fire drill with the team is the best way to maintain a state of preparedness; the team should be familiar with the hedge funds that have made activist approaches generally and be particularly focused on those that have approached other companies in the same industry and the tactics each fund has used.
- Periodic updates to the company's board of directors.

Shareholder Relations:

- The investor relations officer is critical in assessing exposure to an activist attack and in a proxy solicitation. The regard in which the investor relations officer is held by the institutional shareholders has been determinative in a number of proxy solicitations. Candid assessment of shareholder sentiment should be appropriately communicated to senior management, with periodic briefings provided to the board.

- Review capital return policy (dividends and buybacks), broader capital allocation framework, analyst and investor presentations and other financial public relations matters (including disclosed metrics and guidance).
- Monitor peer group, sell-side analysts, proxy advisors, activist institutions, and internet commentary and media reports for opinions or facts that will attract the attention of activists.
- Be consistent with the company's basic strategic message.
- Objectively assess input from shareholders and whether the company is receiving candid feedback.
- Proactively address reasons for any shortfall versus peer benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers. Monitor peer activity and the changes peers are making to their business.
- Build credibility with shareholders and analysts before activists surface.
- Monitor changes in hedge fund and institutional shareholder holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders, paying close attention to activist funds that commonly act together or with an institutional investor.
- Maintain regular contact with major institutional investors and understand their policies; CEO, CFO and independent director participation is very important; regularly engage with both portfolio managers and proxy voting/governance departments.
- Monitor third-party governance ratings and reports for inaccuracies and flawed characterization.
- Major institutional investors, including BlackRock, Fidelity, State Street and Vanguard have established significant proxy departments that make decisions independent of ISS and warrant careful attention. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision-makers and point-persons are and how best to reach them. It is possible to mount a strong defense against an activist attack supported by ISS and gain the support of the major institutional shareholders.
- Maintain up-to-date plans for contacts with media, regulatory agencies, political bodies and industry leaders and refresh relationships.
- Monitor conference call participants, one-on-one requests and transcript downloads.
- Continue temperature taking calls pre- and post-earnings releases and investor conferences.

Prepare the Board of Directors to Deal with the Activist Situation:

- Maintaining a unified board consensus on key strategic issues is essential to success; in large measure an attack by an activist hedge fund is an attempt to drive a wedge between the board and management by raising doubts about strategy and management performance and to create divisions on the board by advocating that a special committee be formed.
- Keep the board informed of options and alternatives analyzed by management, and review with the board basic strategy, capital allocation and the portfolio of businesses in light of possible arguments for spinoffs, share buybacks, increased leverage, special dividends, sale of the company or other structural or business changes.
- Schedule periodic presentations by the legal counsel and the investment banker to familiarize directors with the current activist environment.
- Directors must guard against subversion of the responsibilities of the full board by the activists or related parties and should refer all approaches to the CEO.

- Boardroom debates over business strategy, direction and other matters should be open and vigorous but kept within the boardroom.
- Avoid being put in play; recognize that psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a target.
- A company should not wait until it is involved in a contested proxy solicitation to have its key institutional shareholders meet its independent directors. Many major institutional investors have recommended that companies offer scheduled meetings with some (or all) of a company's independent directors. A disciplined, thoughtful program for periodic meetings is advisable.
- Scrutiny of board composition is increasing, and boards should self-assess regularly. In a contested proxy solicitation, institutional investors may particularly question the "independence" of directors who are older than 75 or who have served for more than 10 to 15 years, in addition to more broadly assessing director expertise and attributes. Meaningful director evaluation is now a key objective of institutional investors, and a corporation is well advised to have it and talk to investors about it. Regular board renewal and refreshment can be important evidence of meaningful evaluation.

Monitor Trading, Volume and Other Indicia of Activity:

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

## The Activist White Paper

The activist may approach a company with an extensive high-quality analysis of the company's business that supports the activist's recommendations (demands) for:

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

The white paper is used by the activist in private meetings with shareholders, sell-side analysts and the media and is ultimately designed for public consumption.

## Responding to an Activist Approach

Response to Non-Public Communication:

- Assemble team and determine initial strategy. Response is an art, not a science.

- No duty to discuss or negotiate, but usually advisable to meet with the activist and discuss the activist's criticisms and proposals (no outright rejection absent study, try to learn as much as possible by listening and keep in mind that it may be desirable to at some point negotiate with the activist and that developing a framework for private communication may avoid escalation).
- Basically no immediate duty to disclose; determine when disclosure may be required, or desirable.
- Response to any particular approach must be specially structured; team should confer to decide proper response.
- Keep board advised (in some cases it may be advisable to arrange for the activist to present its white paper to the board or a committee or subset of the directors).
- No duty to respond, but failure to respond may have negative consequences.
- Be prepared for public disclosure by activist.
- Be prepared for the activist to contact directors, shareholders, sell-side analysts, business partners, employees and key corporate constituencies.

Response to Public Communication:

- Initially, no response other than "the board will consider and welcomes input from its shareholders."
- Assemble team; inform directors.
- Call special board meeting to meet with team and consider the communication.
- Determine board's response and whether to meet with activist. Even in public situations, consider pursuing disciplined engagement with the activist. Failure to meet may also be viewed negatively by institutional investors. Recognize that the activist may mischaracterize what occurs in meetings.
- Avoid mixed messages and preserve the credibility of the board and management.
- Continuously gauge whether the best outcome is to agree upon board representation and/or strategic business or other change in order to avoid a proxy fight.
- Be prepared and willing to defend vigorously.
- Appreciate that the public dialogue is often asymmetrical; activists can make personal attacks and use aggressive language, but the company is limited in responding similarly.
- Remain focused on the business; activist approaches can be all-consuming, but continued strong performance, though not an absolute defense, is one of the best defenses. When business challenges inevitably arise, act in a manner that preserves and builds credibility with shareholders. Maintain the confidence and morale of employees, partners and constituencies.
- The 2015 defeat by DuPont of Trian Partners' short-slate proxy solicitations supported by ISS shows that investors can be persuaded to not blindly follow the recommendation of ISS. When presented with a well-articulated and compelling plan for the long-term success of a company, they are able to cut through the cacophony of short-sighted gains promised by activists touting short-term strategies. The DuPont fight showed that when a company's management and directors work together to clearly present a compelling long-term strategy for value creation, investors will listen.

Martin Lipton
Sabastian V. Niles