Shareholder activism is perhaps the most important M&A development of the past decade. The number of activists, the amount of capital they have at their disposal, the range of their targets, the scope of their activities and tactics, and the success of their efforts all continue to expand significantly. While they were initially derided as 1980s-style corporate raiders and excoriated for self-interested agendas at the expense of companies’ long-term growth prospects, shareholder activists today are often admired for their tenacity and success in forcing change in corporate boardrooms and enhancing shareholder value.

Now a persistent force in corporate America, activists continue to seek new areas and creative methods of influence. Having initially focused on changing corporate governance and then on influencing business structure and strategy, activists now have emerged as significant players in the M&A arena. Corporate boards must be prepared to respond to possible activist challenges to planned M&A transactions, as well as possible M&A transactions instigated or proposed by activists themselves.

1. Shareholder Activism in M&A-- Preparation & Response

- General advance planning. To be ready for a possible future challenge of any type (whether or not M&A-related) from a shareholder activist, a board should:

  - Ensure good general board process and practices. As a general matter, the board and management should be engaged in a functioning process that is focused on the shareholders’ best interests. In this regard, the directors and management should engage in a balanced dialogue about the company’s business plan and strategic direction, analyzing benefits and risks, as well as possible alternatives. Information flow to the board-- with directors taking the time for review, questions and reflection, in an open board environment that promotes healthy skepticism and constructive criticism-- is the critical foundation for the exercise of business judgment.

  - Know the company. The board obviously must understand the company, its peer group and its industry, including emerging issues and strategic direction. The directors must understand the metrics of the company and must focus on any unusual or unexpected developments-- including for example, sudden changes (up or down) in operating or financial results or stock performance; potential compliance, accounting, reporting, litigation or contingent liability issues; employee hotline calls or social media attention; and so on.

  - Know shareholders’ concerns and ensure the effectiveness of the company’s communications and public relations programs. The perception and assessment of the company by its shareholders and the financial community generally are critical factors in the board’s ability to achieve the best results for shareholders, as well as to anticipate and respond to challenges from activists. Effective outreach to and ongoing communication with the company’s...
major shareholders (as well as the investment community at large) is critical. The company should know and understand the concerns of these constituencies, both generally and with respect to the company specifically. It is important that the company has a consistent, reasoned and compelling story to tell about its present and its future, and that it is effectively communicated at every opportunity.

- **Review potential vulnerabilities.** The board should be vigilant in reviewing its general business and strategy and should identify those areas that might be of particular concern to investors (whether because of historical problems or difficulties that have developed in an area; areas that have attracted attention at other companies or in the industry generally; or areas that are problematic due to factors unique to the company). The company should be proactive in identifying and addressing shortcomings and vulnerabilities, including substantive responses to ameliorate issues, as well as effective communications strategies to preempt or respond to investor dissatisfaction. The company should try to anticipate what areas of vulnerability it may have in terms of attracting an activist challenge-- such as, having real estate that could be monetized; holding a large amount of cash that could be returned to shareholders; owning underperforming or unrelated business units that could be sold or spun-off; or underperforming peer companies in terms of financial results or stock performance. Certain governance issues also attract activists’ attention, including executive compensation that is higher than average or not sufficiently related to performance; lack of board turnover or expertise; related party transactions; and corporate governance that is not on par with best practices or is disfavored by activists. The board should have ready explanations for its decisions in these areas that may be likely to be questioned.

- **Monitor interest in the company and changes in the shareholder base.** It is important that the board be aware of the investment community’s views about the company-- including shareholders, proxy advisory firms, analysts and activist groups. The board also should monitor activist challenges and proxy advisory concerns at other companies in its industry to develop sensitivity to the types of issues and events that are likely to attract the attention of activists. The board should understand the composition of the company’s shareholder base and monitor changes on a regular basis. Special attention should be paid to activists, hedge funds and institutional investors, particularly those that are known to act together. The company and its advisors should be proactive in identifying and monitoring any rumors about the company.

- **Monitor activity in the company’s stock and options.** It is critical that programs be in place to monitor activity in the company’s stock and options. The programs should be designed to reveal at the earliest possible time a possible “secret” market accumulation of the company’s stock or options or general buying by activists.

- **Assemble a team.** A small team that can effectively prepare for and respond to an activist challenge should be identified prior to any approach by an activist. The team should include senior officers of the company (including the General Counsel), as well as the company’s outside legal counsel, investment banker, proxy solicitor and public relations firm. On an ongoing basis, the team should be responsible for, and know the results of, many of the action items listed above, and should keep the board informed as appropriate. The team should ensure that the board and management are instructed that any approach by or relating to possible activist interest in the company should be referred to a designated person (generally, the CEO or General Counsel). The team must be aware of the company’s defensive posture-- that is,
whether it has a classified board; has an advance notice bylaw; is incorporated in Delaware or a state with more target-friendly provisions, such as Pennsylvania, Virginia or Ohio; and so on.

- **Advance planning with respect to an M&A transaction.** In addition to the foregoing, in the context of a proposed extraordinary transaction, a board should:
  
  - **Consider the vulnerabilities of the transaction.** The board should identify and be prepared to defend any aspects of the transaction that are likely to attract challenge. Of course, transactions that are “interested” (such as those involving a controlling shareholder, management participation, or conflicts of interest at the board or management levels) will be likely to attract challenges.
  
  - **Consider structuring the transaction to increase the likelihood of shareholder approval.** Most fundamentally, a pristine process, with a meaningful market check and effective minority shareholder protections, and a well functioning board with effective investment bankers and legal counsel, will increase the likelihood of obtaining required shareholder approval of a transaction. (For process guidelines for boards, bankers and controllers, see here our Memorandum, “Thoughts on the Most Recent Delaware Decisions: Part II – GUIDELINES for Controlling Shareholders, Special Committees and Investment Bankers”.)

  Also, certain deal terms can affect a transaction’s vulnerability to challenge. Crafting the deal terms involves a careful and nuanced analysis of the facts and circumstances. For example, conditioning a transaction on approval by the minority shareholders based on a majority of all outstanding shares—rather than a majority of the votes cast—can be an effective minority shareholder protection, but also can jeopardize the shareholder vote if shareholders are encouraged to seek appraisal rights or otherwise not to vote for the transaction (as every vote not voted “for” will in effect be counted as “against” in this scenario, making it difficult to obtain the required vote for the transaction). Another example is that conditioning a transaction on not more than a specified percentage of shares seeking appraisal rights may affect the likelihood of obtaining the required shareholder vote. (For a discussion of the effect of voting terms on activist Carl Icahn’s challenge to the Dell management buyout and a discussion of appraisal rights conditions, see here our Memorandum, “Appraisal Arbitrage—A New Activist Weapon”.)

  - **Consider the company’s takeover defensive posture.** The board should consider all possible types of attacks by activists in response to a transaction, including a possible unsolicited bid for the company by activists or by bidders supported by activists. The board should consider the company’s defensive readiness for such an attack.

  - **Redouble efforts in all other planning areas.** In the context of an extraordinary transaction, efforts with respect to each of the advance planning guidelines set forth above should be redoubled. Thus, for example, a team dedicated to responding to activist challenges should be in place and fully prepared to act; monitoring of activity in stock and options is critical (including while the transaction is being planned and considered); the company’s communications and public relations programs with respect to the transaction must be well developed and implemented; and so forth.

- **Response to an activist’s approach or public challenge.** Here, a checklist approach is inapposite. Once a company has been approached by an activist with respect to an M&A transaction, the
response will depend on a nuanced assessment of all the facts and circumstances at the time by the board, management and the company’s outside advisors.

The critical factors and decisions will be:

- whether the activist has made a private approach or a public challenge-- however, the board should assume that even a private approach will have a high potential for becoming a public challenge; and
- whether, when and how to engage in discussions or negotiations with the activist.

The guiding principles must be:

- coordinating all action through the dedicated team;
- maintaining the company’s credibility in the face of pressure (and, often, aggressive attacks) from the activist;
- communicating a compelling rationale for a transaction under attack and a consistent and effective message about the company’s long-term strategy for value creation;
- continuing to focus on ensuring the company’s strong performance and good reputation; and
- understanding that compromise, not “war”, can be a sensible resolution of an activist encounter.

Automatic stonewalling of an activist is no longer the settled course. Depending on the circumstances, acknowledging the activist quickly and constructively may be the best way to proceed. Open communication can serve the company, the shareholders and the activist. The critical inquiry will include: What does the activist have to say? Are the ideas consistent with the objectives of investors in the company generally? What is the activist’s history in terms of approach and result? In all events, the objective will be to develop a thoughtful balance in the reaction to an activist challenge-- trying to avoid “war” and its potential for significant distraction of the board and management from the real business of the company (with the attendant expense and unpleasantness); while not capitulating to ideas that are not in the company’s interest. Negotiation and compromise should be evaluated as a possibility and, when feasible, may best serve the company.

Questions About the Future of Shareholder Activism in M&A

There is no doubt that the reach of activism is continuing to expand. Activists have more capital available to them, target larger and better performing companies, have had more success, and have targeted a wider array of corporate issues than in the past. Their geographic reach has extended beyond North America to Europe, and now to Latin America and beyond. (See here our Memorandum, “Shareholder Activism Spreads Globally”.) Activists have already changed how corporations act and how deals get done. Announced transactions are often challenged by activists; deals being considered are structured to take into account the possibility of activist involvement; activists are instigating deals that otherwise would not have been considered; deals that might have been proposed may not be so as to avoid attracting activist attention. The future of shareholder activism in M&A will depend on a number of considerations.

- What will activists have to do to remain relevant? Although today’s activists are in many ways a reincarnation of the corporate raiders of the 1980s, they have exerted much effort in portraying
themselves, unlike the raiders, as interested in enhancing value for all shareholders and not just in personal profiteering. While activists are criticized by some for having short-term self-interested motives, many activists claim to focus on long-term issues and hold their positions for extended periods of time. Most of the changes they advocate appear to affect all shareholders equally rather than being especially beneficial for the activist. Of course, there are numerous examples of activists acting in clearly or potentially self-interested ways. Will the activists as a group tend to become more focused or less focused on self-interest and short-term gain? Will more influential activists try to impose discipline on others in order to protect the value of the brand of activists generally against behavior that would negate a view that activists have all shareholders interests at heart? As activists expand to the M&A arena, will the greater potential for regulatory and insider trading violations, and the greater scrutiny by regulators, lead to the kinds of problems that contributed to the downfall of the corporate raiders a generation ago?

One trend seen within the last year is the move by activists at nine companies (more than in the six previous years combined) to cause the company to buy back the shares owned by the activist. Reminiscent of the “greenmail” extorted by corporate raiders in the 1980s, these stock buybacks are often combined with an agreement by the activist to resign its board positions, to not acquire more shares, or to vote its remaining shares in favor of the board’s nominees for a period of time. Depending on the circumstances, a buyback of shares from an activist may be beneficial to shareholders generally. In fact, most of these buyouts have been at a slight discount to the market price of the stock (albeit a higher price than the activist could obtain if it sold a large stake into the market). However, at least one recent buyback was at a premium to market. Just as the blatant self-interest of “greenmail” led to an outcry by companies and investors against raiders-- and, ultimately, to laws restricting their tactics and making them virtually obsolete (including a 50% federal excise tax on certain greenmail gains)-- a move toward a more self-interested focus by activists may create a backlash against them that could lead to a reduction in their influence.

**Will the power of proxy firms diminish?** Much of the power of activists, both generally and in M&A specifically, has been derived from the policies and influence of proxy firms. Proxy firms have been directing institutional investors how to vote their shares and most institutional investors have faithfully followed the recommendations. More recently, however, larger institutional investors have begun to analyze M&A (and other) situations on their own, with internal staff and external consultants, reaching their own conclusions about specific situations and not always following their proxy firm’s lead. Moreover, there appears to be more of a divergence in the voting recommendations of the major proxy firms (that is, ISS and Glass Lewis) than there has been in the past. Finally, there has been some regulatory movement toward requiring greater oversight of proxy firms by the investment advisors that engage them, including in the area of disclosure of their conflicts of interest when making voting recommendations. All of these may lead to a reduction in the power of proxy firms to unify the response of institutional shareholders to activist campaigns.

**Will a change in financial liquidity in the market reduce the influence of activists?** It remains to be seen what impact changes in the current very high level of transaction activity, exceptionally low interest rates, and exceptionally high level of financial liquidity will have on the activity and influence of activists. Specifically, to what extent will reductions in the availability of financing and increases in interest rates reduce the funds available to activists to take the number and size of positions that they currently take? Additionally, will increases in interest rates, and the availability to investors of other
investments with higher yields than are available currently, impact the ability of activists to generate the types of above market returns that have resulted in such significant investment in activist funds?

**Will corporate America take action to try to establish a new paradigm of corporate governance that satisfies the underlying concerns that motivate shareholders to support activists?** The foundation for the rise of activists has been the inherent conflicts that arise in a corporate governance regime such as ours that separates ownership and management of companies. In considering corporate governance issues, will boards have the inclination and ability to move toward a new equilibrium among directors, managers and shareholders that will reestablish more of a commonality of interest among them in ensuring best practice governance that avoids entrenchment and facilitates responsiveness to shareholder interests? (As one example, in the context of consideration of the activist campaign to declassify boards, we have suggested compromise positions, as alternatives to the stark choice of retaining or eliminating traditional classified boards, that could be considered and would preserve the corporate benefits that classified boards offer while guarding against entrenchment and lack of responsiveness to shareholder concerns, including in a takeover situation. See here our Memorandum, “A New Approach for Classified Boards: Can the Paradigm Be Changed — to Retain Value-Enhancement While Addressing Director Accountability?”)

The activist world continues to grow in size, reach and innovation. Activists challenge and initiate M&A transactions with increasing frequency and success. Many of the more established activists have stunning access to capital and can acquire significant equity stakes in very large companies (as with Bill Ackman’s recent acquisition of an almost 10% stake in Allergan for about $4 billion). Other activists act in “wolf packs” and exert further pressure on a target company in support of the initial activist’s investment. Presumably, there is no company large enough to be immune from what has become the activists’ most successful strategy— a stealth market accumulation of a significant equity stake followed by a campaign to achieve a specific agenda. If a company is too large for any one activist to acquire a significant stake on its own, one can expect that activists will simply evolve to a model in which they act together from the outset. While the debate continues as to whether activists are boon or bane to corporate America and its shareholders, there is no doubt that this is, and for the foreseeable future will remain, the age of the activist— no less so in M&A than in other spheres.

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