

COMPLIANCE WEEK

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Prepare For Attack: What To Do When Hedge Funds Move In

By Neil O'Hara — March 28, 2006

As any good corporate executive knows, hedge funds can attack quickly, causing all sorts of headaches as they grab headlines and shareholder attention with calls for various reforms.

Little surprise, then, that experts now recommend companies create “rapid response teams” to defend themselves.

A recent memo from law firm Wachtell, Lipton, Rosen & Katz urges companies to prepare for a possible activist attack as if it were a hostile takeover bid. Under this approach, a response team, including key officers, lawyers, investment bankers, a proxy solicitor and a financial public relations firm, meets periodically to review changes in the shareholder base and market intelligence from analysts, media and major shareholders. Wachtell recommends companies engage a stock-watch service, too, and prepare the directors, who “must guard against subversion by the activist or related parties” (see box at right).



Drake

In practice, many companies don't bother until the first sign of trouble—and then have to scramble, according to David Drake, senior managing director of Georgeson Proxy. Even if a company has a defense team in place, Drake says, often that team doesn't have regular meetings. “They use a stock-watch service to alert them when hedge funds are accumulating a large position in the stock,” he says. “If they see anything out of the ordinary they begin to contact their advisers.”

A company's response may depend on how the shareholder base shifts when activists pounce. Last year activists took on Beverly Enterprises, a \$1.9 billion nursing-home operator that was undergoing a turnaround supported by its long-term shareholders. Those same holders sold in droves when activists proposed an auction to the highest bidder. Hedge funds and arbitrageurs quickly boosted their holdings from roughly 10 percent to a majority, according to Drake. “Some people speculated this happened within a week,” he says. “The ability of hedge funds to communicate with each other and attract other hedge funds into the game quickly is a very powerful tool.” Beverly ultimately sold itself to Pearl Senior Care, owned by private equity firm Fillmore Capital Partners.

Weakened Defenses

Companies are more vulnerable today thanks to an earlier generation of activists—mostly union and public-employee pension plans—that pushed for declassified boards and the elimination of poison pills. “The ability to take over the entire board of directors at a single meeting is a formidable lever for an activist,” says Warren de Wied, a partner and head of the merger and acquisition practice at Fried, Frank, Harris, Shriver & Jacobson. He sees declassification as a double-edged sword for companies: They win points for good governance, but expose themselves to activist campaigns that may favor short-term gains over long-term value.

Poison pills present a similar dilemma. Drake notes that a poison pill does stop buyers going beyond the trigger threshold, but because activist campaigns usually have a corporate governance component, a company that deploys a pill may stand accused of entrenching management. “It’s a paradox,” Drake says. “The best tool you have to prevent further accumulation gives a weapon to a dissident investor to convince shareholders that management is not acting on their behalf.”

Drake believes companies can moot the accusation if they commit to put any poison pill to a shareholder vote within 12 months of adoption. That gives companies some time to negotiate with hedge funds. “It’s not a permanent fix,” Drake says, but “it gives you more time to meet with all your investors to see if you can work through the situation.”

Majority voting for the election of directors escalates pressure as well. Under plurality voting, a board could ignore a shareholder resolution to remove takeover defenses with impunity; even if most shareholders withheld their votes the following year, Drake notes, directors were still re-elected. “It was really nothing more than a non-binding protest,” he says. “With more companies adopting majority voting, the implications of not redeeming a pill or de-staggering the board as requested are far more serious.”

Counterattack Via Communication

Unable to hide behind impregnable takeover defenses, companies now prefer to reach out to activists, Drake says. He cites Time Warner’s response to Carl Icahn as an example. The erstwhile corporate raider bought into Time Warner’s shareholder base last year and needed management to break up the company, but won little support among traditional institutions or even other hedge funds partly because Time Warner CEO Dick Parsons opened lines of communication rather than treating Icahn as a hostile shareholder. “The initial reaction used to be to stiff arm the investor,” says Drake, “We are moving toward a phase where the decision is made to engage the investor instead.”

The Business Roundtable has embraced this approach. Its Guidelines for Shareholder-Director Communications, published in May 2005, recommend that companies establish procedures for shareholders to communicate with the board (see box above, right). In turn, directors should oversee the response to shareholder proposals and ensure communications with shareholders are consistent, clear and candid. “We feel very strongly that will lead to better relations with shareholder activists,” says Tom Lehner, the Roundtable’s director of public policy. “If you have a meaningful dialogue with people on the other side of the table, chances are there is going to be less animosity.”



Lehner

To date, hedge funds have mounted few campaigns against Business Roundtable members—160 of the nation’s largest companies—although Lehner expects to see more in the future. He points out that talking to activists doesn’t mean companies have to implement everything they suggest. “Shareholders own companies, but don’t run them,” Lehner says. “Shareholders aren’t responsible for the business decisions that limited liability corporations make.” He believes that even activist shareholders recognize that companies must cater to other constituencies, including employees, customers, suppliers and the communities the companies serve. “It’s simply not reasonable for a small vocal group to come in and dictate the behavior of the entire organization,” Lehner says.



De Wied

Ideally, an effective corporate communications program would keep the stock price close to fair value and eliminate the valuation disparities activists seek to exploit. The best defense is good performance, but de Wied points out that companies don’t always recognize problems and fix them in time. If activists do launch a campaign, he believes the available takeover defenses matter less than the attitude of the board. “Look at Knight-Ridder, which had everything,” de Wied says of the newspaper chain that recently sold itself to a rival chain. “In the face of a concerted campaign by an activist shareholder, the company didn’t rely upon the fact that it had a staggered board and so on. It made the determination that the best course of action was to pursue a transaction.”

Although de Wied expects heightened activism to continue, he does not believe hedge funds will always get their way. Activists will suffer increased scrutiny by their targets, which will seize on any compliance or governance problems at hedge funds to discredit the attackers. “It’s a very tough area in which people take aggressive positions and pursue a range of tactics, not all of which are gentlemanly,” de Wied says. “Some people are prepared for that. Others are not.”

RECOMMENDATIONS

Below are some recommendations from Wachtell Lipton on how to prepare for and respond to hedge funds:

- Create a team to deal with hedge fund activism, essentially the same as a takeover response team: a small group (two to five people) of key officers plus a lawyer, investment banker, proxy soliciting firm and public relations firm.
- Ensure ability to convene a special meeting of the board of directors within 48 hours.
- Review dividend policy, analyst and investor presentations and other financial public relations.
- Proactively address reasons for any shortfall in peer company benchmarks; anticipate key questions and challenges from activists, and be prepared with answers.
- Monitor changes in hedge fund and institutional holdings on a regular basis; understand the shareholder base including, to the extent possible, relationships among holders.
- Schedule periodic presentations by lawyers and investment bankers to familiarize directors with current activist environment.

Source

‘Attacks By Activists Hedge Funds,’ Wachtell Lipton (March 7, 2006)

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