Shareholder Activism, Proxy Fights and Hostile Deals

The 31st Annual Federal Securities Institute
Miami, Florida
February 14, 2013
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Shareholder Activism, Proxy Fights and Hostile Deals

<table>
<thead>
<tr>
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Overview of Governance Activism

- Governance activism driven largely by public pension funds, unions and individual “gadflies”
  - Supported by proxy advisory firms and institutional shareholder voting policies
- Focus over last decade on increasing shareholder power and limiting board/management power
  - Dismantling takeover defenses, majority voting, separation of Chair and CEO
- Organized issue campaigns by groups such as the Harvard Shareholder Rights Project and individuals such as John Chevedden
# Dismantling of Takeover Defenses: 2002 to 2012

<table>
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<tr>
<th>Takeover Defense</th>
<th>% of S&amp;P 500 Companies</th>
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<tbody>
<tr>
<td></td>
<td>2002</td>
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<tr>
<td>Poison Pill</td>
<td>60%</td>
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<tr>
<td>Classified Board</td>
<td>61%</td>
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<tr>
<td>Supermajority Vote to Remove Directors</td>
<td>33%</td>
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<tr>
<td>Shareholders Cannot Call Special Meetings</td>
<td>59%</td>
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<tr>
<td>No Action by Written Consent</td>
<td>73%</td>
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Other Governance Proposals

- Close to 80% of S&P 500 companies have adopted some form of majority voting
  - Director resignation offer form provides greater flexibility for the board and was validated by Axcelis case
- Investor activists continue to push for majority voting at mid- and small-cap companies
  - The Council of Institutional Investors has been aggressive in pursuing this issue
- Other common proposals include separation of Chair and CEO, elimination of super-majority voting requirements, and compensation-related proposals
Proxy Access

- SEC adopted rules in 2010; struck down by court in 2011
- Amendments to Rule 14a-8 to permit proxy access shareholder proposals went into effect in 2012
- Nine proxy access proposals came to a vote in 2012; only two, both precatory, received a majority vote
  - ISS will recommend withhold vote on directors who are not responsive to majority-approved shareholder proposal
  - At least one of the two companies has already responded by announcing plans to implement proxy access
- Two microcap companies in 2012 voluntarily permitted shareholders to place nominees on the company ballot
Proxy Plumbing

- SEC issued Concept Release on proxy infrastructure on July 14, 2010

- Matters covered include:
  - Role of proxy advisory firms
  - Share lending and empty voting
  - Communications with shareholders (NOBO/OBOs)
  - Under-voting and over-voting
  - Retail voting (including client-directed voting)

- No rulemaking to date
Shareholder Activism, Proxy Fights and Hostile Deals

- Governance Activism
- Activism and Executive Compensation
- Economic Activism
- Company Communications
- Proxy Fights
- Hostile Deals
Say on Pay (SOP) – Overview

- 2012 was second year of mandatory SOP
- Continues to be the dominant factor affecting executive compensation
- Significant impact on disclosure practices
- Increasing impact on actual pay practices and design
SOP – Voting Results in 2012

- Votes failed (less than 50%) through July:
  - 53 (2.4% of all companies, up from 1.3% in 2011)
  - S&P 500 – 12 (3%, up from 1.2% in 2012)

- Less than 70% support:
  - 176 (8%), up slightly on a percentage basis from 2011
  - 45 (11%) in the S&P 500, also up slightly on percentage basis

- Average vote in favor – 91%
  - When ISS recommended for, average was 94%
  - When ISS recommended against, average was 64%
SOP – Why Negative Votes

➢ CEO pay-for-performance disconnect
  ➢ Rise of the “Executive Summary”
  ➢ Making the pay-for-performance connection

➢ Problematic pay practices
  ➢ Severance/change-of-control arrangements
  ➢ Peer group benchmarking
  ➢ Non-performance pay elements
SOP – Responses to Negative Vote

- Improved disclosure
  - Focus is on the CEO
  - Other executives matter, but not nearly as much

- Shareholder engagement
  - Particularly if prior year vote < 70%, demonstrate outreach to key shareholders
  - Describe outreach efforts in the CD&A
  - Engage with ISS during the “off season”
SOP – Responses to Negative Vote (cont.)

- Changes to pay programs
  - Consider peer group changes
  - Avoid discretionary bonuses
  - Increase proportion of performance-based equity
  - Eliminate “above median” benchmarking
  - Reduce CEO pay

- Improved “hygiene”
  - Reduce or eliminate perquisites
  - Eliminate tax gross ups
  - Eliminate single trigger change-of-control agreements
  - Reduce excessive severance multiples
SOP – Responses to Negative Vote (cont.)

- Adopt and highlight best practices
  - Stock ownership/hold until retirement policies
  - Clawback policy
  - Anti-hedging/pledging policy
SOP – Negative ISS Recommendation

- Change ISS’s mind?
  - **Very** low probability

- Understand your shareholders and how they treat ISS recommendations
  - Get to the decision maker
  - Portfolio manager may not be relevant to voting decision
SOP – Supplemental Proxy Material

- Effectiveness is unproven
- Can be helpful to summarize key points
- Q&A format is user friendly
  - See Johnson & Johnson (4/20/2012)
- Remember filing obligations
  - Written materials that are sent must be filed
  - Scripts should be filed
  - Talking points likely need not be
2013 ISS Policy Updates – New Peer Group Selection Method

- Generally 14-24 companies per peer group
  - Subject to size constraints and keeping the company at or near the median size, peers selected by starting with 8-digit GICS group, then moving to 6-digit and then 4-digit
  - Priority given to companies in the target company’s GICS group then to the GICS groups of its chosen peers
  - Priority given to “first degree” peers (e.g., Company’s chosen peers, companies choosing the Company)
  - 42% of companies (up from 20%) expected to have an ISS peer group with at least 50% of self-selected peer group
  - Companies can inform ISS about changes to self-selected peer groups
- ISS anticipates quantitative screen will not change for >95% of companies
2013 ISS Policy Updates – Realizable Pay

- ISS may consider realizable pay vs. granted pay in qualitative evaluation of pay for performance analysis
- ISS will report realizable pay for large cap companies
- What is Realizable Pay?
  - Amounts actually paid or realized, or the current value of incentive grants made, during a measurement period (usually 3 fiscal years) as of the end of the period
  - “Realized” pay is closely related (but not separately considered by ISS)
2013 ISS Policy Updates – Components of “Realizable Pay”

- **Base salary** for all years in measurement period
- **Bonus** for all years in measurement period
- **Short-term awards** (typically annual) reported as Non-equity Incentive Plan Compensation for all years in measurement period
- **Long-Term Cash Awards**: earned value if earned during measurement period; target value if performance period not completed within period
- **Share-Based Awards**: value (based on stock price at end of measurement period) if earned during measuring period; target value if performance period not completed within period
- **Stock Options**: net value realized with respect to options that were granted and exercised within measurement period; Black-Scholes value as of the end of period for options granted but not exercised during period
- **Change in Pension Value and Non-Qualified Deferred Compensation Earnings**
- **All Other Compensation** reported for all years in measuring period
2013 ISS Policy Updates – “Realizable Pay” Disclosure Issues

- Why disclose Realizable Pay?
  - Summary Compensation Table does not reflect final payouts of performance-based awards or changes in value
  - Using realizable pay may paint a better picture for investors of alignment with total shareholder return

- Potential Disclosure Pitfalls
  - SEC has urged caution because disclosure is not required and could be misleading
  - No uniformly recognized definition of “realizable pay”
  - Using realizable pay will not always show desired pay-for-performance alignment
2013 ISS Policy Updates – Hedging and Pledging

- **Hedging**
  - Any hedging of risk relating to owning issuer stock by executives or directors considered a problematic pay practice
  - Hedging will result in negative recommendation on election of appropriate directors

- **Pledging**
  - ISS will take case-by-case approach in determining response to pledging of issuer stock by executives or directors
  - Significant pledging may lead to negative recommendation on election of appropriate directors
  - Existence of anti-pledging policy and other factors considered in determining director vote recommendation
2013 ISS Policy Updates – Voting on Golden Parachutes

- New policy to also consider *existing* change-in-control arrangements with NEOs rather than merely new or extended arrangements
- Recent additions of problematic features (e.g. single-trigger payments, >3x severance, etc.) carry more weight
- Heightened scrutiny for multiple problematic features
- Recommendations on SoGP still done on case-by-case basis
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What Do Economic Activists Want?

- Economic activist proposals typically focus on “value maximizing” events, but in recent years have also focused on management, governance and strategy.

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<th>“Value Maximization” Events</th>
<th>Other Proposals</th>
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<td>• Sale of company or division</td>
<td>• Management change</td>
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<tr>
<td>• Leveraged recapitalization</td>
<td>• Board change</td>
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<tr>
<td>• Return of cash to shareholders</td>
<td>• Compensation reform</td>
</tr>
<tr>
<td>• Spin-off</td>
<td>• New business strategies</td>
</tr>
<tr>
<td>• Oppose transaction or demand increase in consideration</td>
<td>• New capital allocation strategies</td>
</tr>
<tr>
<td></td>
<td>• Operational improvements</td>
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## Some Economic Activist Strategies

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<th>Build Stake</th>
<th>Engagement</th>
<th>Seek Influence</th>
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<tr>
<td>• Accumulate initial stake</td>
<td>• Request meetings</td>
<td>• Request board seats</td>
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<tr>
<td>• File HSR</td>
<td>• Send private or public letters</td>
<td>• Launch short-slate proxy contest</td>
</tr>
<tr>
<td>• Continue to build stake</td>
<td>• Threaten “withhold the vote” campaign</td>
<td>• Launch full-slate proxy contest</td>
</tr>
<tr>
<td>• File 13D</td>
<td>• Threaten to vote against board proposals</td>
<td>• Make public bear hug or offer (rarely)</td>
</tr>
<tr>
<td>• Team up with other activists</td>
<td>• Seek to rally other investors</td>
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Steps to Take Before an Activist Surfaces

- Establish core team – internal and external
- Assess and address vulnerabilities – how would an activist look at the company
  - Are there steps an activist might propose that should be considered preemptively
- Clarity of business strategy – reasons for pursuing or not pursuing various strategies
- Track peer performance
  - How does the company compare to its peers
  - Transparency on dealing with poor results
- Stay close to shareholders
  - Maintain robust shareholder communications program
The Perspective of an Economic Activist

- What attracts an economic activist to become interested in a company
- After making an investment, what causes an economic activist to take more aggressive actions
- How are relationships between and among economic activists formed and developed
- What is the relationship between economic activists and the proxy advisory services
- What do companies do that either make an economic activist more or less likely to support the company
Steps to Consider After an Activist Surfaces

- Meet with the activist
  - Usually advisable to meet with the activist, but may depend on identity of the activist, history and other factors
  - Careful preparation for any such meeting is important; may be a precursor to a proxy contest or other adversarial action

- Consider the activist’s proposals
  - If proposals make sense, may want to explore whether to implement

- Make independent decision
  - It is the board’s responsibility to make decisions it believes are in the best interests of the company and shareholders
Shareholder Activism, Proxy Fights and Hostile Deals

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Shareholder Communications

- Investor relations program
  - Get to know major shareholders before there is a problem
  - Explain rationale behind company’s policies
  - Understand how institutions’ proxy voting process works

- Consider other opinion shapers
  - Analysts, media, political and regulatory bodies, corporate governance “gurus” and other third parties may help shape shareholders’ views

- Monitor trading and commentary
  - Stay current on shareholder profile and who is buying/selling
  - Find appropriate forum to address significant issues raised by shareholders
Communications with Activists

- Assess what kind of activist
  - Gather as much information as possible, including prior history and results, contentiousness, willingness to negotiate, etc.
- Consider who is the best person to communicate
  - Need to balance time demands of senior executives and importance/size of activist
- Listen
  - Activists may have ideas worth considering; keep open mind
  - Don’t need to respond on the spot; can take ideas under advisement
Media Communications

- Keep media relationships fresh
  - Develop relationships prior to being targeted
  - Conduct interviews around planned corporate events (e.g., earnings) or other “easy wins” (e.g. project announcements)

- Identify spokespeople and conduct training as appropriate
  - Media training can help executives feel comfortable in interview setting and avoid mistakes
Board Communications

- Keep board informed
  - Consider periodic review of governance, shareholder activism and M&A activity
  - Helps maintains board cohesiveness and preparation for dealing with any specific issues

- Consider activist requests for meeting with independent directors
  - Be mindful of imposing unnecessary burdens
  - But in some circumstances, agreeing to a meeting with independent directors may be warranted
  - Any such meeting requires careful advance preparation
Every Constituency Counts

- Constituencies communicate with each other
- Success hinges on targeting key influencers within each constituency
- Communications should be consistent, coordinated and focused on a common goal
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Addressing a Threatened Proxy Fight

- Company should be realistic about chances of success
  - Assess company profile and track record
  - Assess how receptive shareholders are likely to be to dissident platform/critique, and how likely advisory services are to recommend in favor of dissident nominees

- Are there steps that can be taken to improve chances of success
  - Consider adding or replacing directors in advance of fight
  - Consider adopting some of dissident’s ideas/platform

- Choosing to fight or to attempt settlement
  - Proxy fights are disruptive and expensive
  - If likelihood of success is low or uncertain, may want to seek early settlement
Proxy Fight Tactics

➢ Dissident typically takes the offensive role
  ➢ Company, board and management team subjected to public criticism, which can take very aggressive tone
  ➢ Track record, strategy and performance all subject to attack

➢ Company typically defends
  ➢ Defend track record, but should also be ready to embrace and defend new strategies and change
  ➢ Can also counterattack against dissident track record, perceived conflicts and any other area of vulnerability

➢ Company often held to higher standard
  ➢ Dissidents may use sharp caustic language, but company well advised to take high road and not respond in kind
Both sides will typically engage in one-on-one meetings with major investors

- Consider timing, frequency and attendees
- For company, CEO and/or executive team best, but may want to include independent directors at selected meetings
- Address role of proxy advisory services
- Consider internal mechanism of each institution for trying to override adverse proxy advisory recommendation

Benefits and risks of large format or group meetings should be carefully considered

- Level of control is significantly diminished
- Tend to favor dissidents, who have broader leeway to attack
Proxy Fight Tactics (cont.)

- Strategies for gaining recommendation of ISS and other proxy advisory services
  - Understand analytic framework that advisory services use in making recommendation
  - ISS typically wants to hear from independent directors as well as management
- Always consider impact of any potential statement or action on voting and recommendation decisions
  - Resist temptation to lash out just because it “feels good”
- Company or dissidents may bring litigation, but typically counterproductive
- Universal ballot – which side does it favor?
Role of Board

- Prepare board from the beginning for potential attacks, including personal attacks on individual directors
- Keep the board “in the loop” and alert board to communications surrounding proxy contest
- Enlist individual directors in selective proxy contest conference calls and meetings, including with ISS
- Encourage directors to have phone screeners to avoid unprepared communications
- Board is ultimately the decision maker with respect to conduct of proxy fight and any possible settlement
Role of Shareholder Advisory Services

- ISS is leading firm in terms of influence
  - Meets with both sides in a proxy contest
  - How does ISS determine its recommendations
  - Is there a bias towards dissidents?
- Glass Lewis is significant competitor of ISS
  - Usually does not meet with company representatives in a proxy contest, but may host a “forum”
- Egan-Jones has far less direct influence on vote, but can still get media attention
After the Proxy Fight

- If dissidents win or are placed on the board through a settlement
  - Welcome new directors and try to integrate them into the board; if that becomes impossible, address at that time
  - In many cases, dissident nominees and companies have worked out constructive relationship

- If company wins
  - Keep “victory celebration” muted; dissident typically remains as significant investor for at least some period of time
  - Continue to try to maintain as constructive a relationship as possible with the dissident
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Hostile Activity and Activism Continues

• Hostile activity hit low in 2009, increasing modestly since then but still significantly below pre-2009 levels

• Proxy contests have also declined, but remain a significant threat by both potential acquirers and activists supporting a sale or restructuring

• “Catalyst investors” bid/agitate just to put companies in play

• Recovering economy and erosion of takeover defenses due to actions of governance activists may create environment that is conducive to future hostile activity

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1 Source: Thomson Reuters. Data as of 1/24/13.
2 Source: SharkRepellent.net. Data as of 1/24/13.
Hostile Activity and Outcome of Bids

U.S. Hostile / Unsolicited M&A Activity

Outcome of Hostile Bids (1997 - 2012)

Value of Deals Announced (US$B)

1 Source: Thomson Reuters (includes deals that began as unsolicited but ended with a negotiated transaction). Data as of 1/24/13.

2 Source: Thomson Reuters (excludes deals for which the outcome is pending). Data as of 1/24/13.
Some recent hostile bids

- Bids that were withdrawn
  - Roche/Illumina
  - Coty/Avon
  - Westlake/Georgia Gulf
  - Genomma/Prestige Brands
  - ConAgra/Ralcorp (but friendly deal completed a year later)

- Bids that were derailed by litigation losses
  - Martin Marietta/Vulcan
  - Air Products/Airgas

- Bids that were completed
  - Icahn/CVR Energy
  - International Paper/Temple Inland
Some considerations for bidders

- Hostile bids are hard
  - Can usually expect a long and difficult battle
  - Success rate is only about 40%

- Important to start strongly
  - Difficult to obtain a “bargain” through a hostile bid
  - Can’t rely on legal strategy

- Timing is important
  - Need ability to run proxy contest if target resists

- Focus on targets board dynamics
  - Can cohesion of target’s board be broken
  - Selection of nominees for proxy contest

- Consider reaction of bidder’s own shareholders
Some considerations for targets

- A unified board is key
  - The hostile bidder will try to pressure the board
  - Whether defending or selling, unity produces better results

- You can usually take your time
  - Board should not be pressured into acting hastily
  - If bid is inadequate, it may be possible to outlast bidder

- The pill is alive and well
  - Airgas upheld the right of the board to maintain a poison pill even after a year to block a premium bid
  - With proper record, may stand behind a pill and just say no

- Defense can help get a better price
  - Provides negotiating leverage if decision is made to sell