ACTIVISM

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1. Hedge Fund Activism

Recent years have seen a resurgence of raider-like activity by activist hedge funds, both in the U.S. and abroad, often aimed at forcing the adoption of policies with the goal of increasing short-term stock prices, such as increases in share buybacks, the sale or spin-off of one or more businesses of a company, or the sale of the entire company. Approximately 25% of S&P 500 companies have an activist among their shareholder base. Activists' assets under management ("AUM") have grown substantially in recent years, although activists ended 2018 with $257 billion in AUM, approximately the same level as the end of 2017. Matters of business strategy, operational improvement, capital allocation and structure, CEO succession, M&A, options for monetizing corporate assets and other economic decisions have also become the subject of shareholder referenda and pressure. Hedge fund activists have also pushed for governance changes as they court proxy advisory services and governance-oriented investors and have run (or threatened) proxy contests, usually for a short slate of directors, though increasingly for control of the board. Activists have also increasingly targeted top management for removal and replacement by activist-sponsored candidates. In addition, activists have worked to block proposed M&A transactions, mostly on the target side but also sometimes on the acquiror side.

2018, as in 2017, featured an explosion of aggressive public campaigns against large-cap and even mega-cap companies, with activism at small and mid-cap enterprises continuing apace. Indeed, notwithstanding significant market volatility in the fourth quarter of 2018, it was the most active fourth quarter on record in terms of campaign volume and capital deployed. Many campaigns ended with announced settlements with activist hedge funds, but several "went the distance" all the way to the 2018 annual meeting. Of the 41.7% of proxy fights that went to a vote in 2018, management won a complete victory in slightly less than 50% of cases, which was comparable to management's success rate of approximately 50% of the proxy fights that went to a vote in 2017. Moreover, there is an increasing number of activism situations across industries that begin—and may be resolved—behind the scenes through private engagement and negotiation. Of the campaigns that resulted in board seats for an activist in 2018, approximately 84% ended via a settlement, the same proportion as in 2017. Some large shareholders are beginning to take note of the trend—for example, State Street has focused on the terms of settlement agreements. Activists gained a record 161 board seats in 2018, an increase of 56% compared to 2017 and higher than the previous record of 145 seats won in 2016. Activists are also increasingly appointing directors who are independent of the activist. Employees of the activist comprised only 22% of the board seats won by activists in 2018, a decline from 27% in each of 2016 and 2017.

2018 also saw growth in foreign activism, with the number of activist campaigns in the European and Asia Pacific regions reaching all-time highs, reaching 23% and 12% of companies targeted, respectively.

While activism remained high in 2018, a number of prominent hedge fund activists suffered losses greater than the overall market, including Third Point Partners and Jana Partners. These losses underscore the investment risk associated with activist hedge funds.

Nevertheless, 131 investors engaged in activism in 2018, the highest on record. Campaigns by large institutional investors and asset managers that are not dedicated activist funds have also burst onto the activism scene over the past few years, as illustrated by Artisan Partners' campaign against $280 billion Johnson & Johnson, Neuberger Berman's campaigns at Whole Foods Market and other companies, and the California State Teachers' Retirement System's ("CalSTRS") partnership with Legion to pressure Papa John's to remain a standalone company.

In today's activism environment, even household-name companies with best-in-class corporate governance and rising share prices may find themselves targeted by shareholder activists represented by well-regarded advisors. The trend of targeting (and sometimes achieving settlements at) high-profile companies in diverse industries has continued over the past three years, as illustrated by activist activity at athenahealth, Automatic Data Processing, Apple, Arconic, Barclays, Bloomin' Brands, Bristol-Myers Squibb, Campbell's, DuPont and Dow, eBay, EQT, General Electric, General Motors ("GM"), Hyundai, Hess, Lowe's, Macy's, PepsiCo, Procter & Gamble, Thyssenkrupp, Tiffany's, Qualcomm, United Technologies, Whole Foods Market, Xerox, and Yahoo!, among others.

Against this backdrop, however, there have recently been signs of a growing recognition that the excesses of shareholder activism threaten the sustainability and future prosperity of the American economy. For example, while institutional investors may sometimes support activist campaigns, several major institutional investors have gone on the record to criticize—and have voted against—the typical activist playbooks, and they have sought to establish and publicize their long-term mindset. The emerging view of a new paradigm for corporate governance, reflected in *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*,[1] recognizes the deleterious effects of short-termism and emphasizes a focus on building strong corporate relationships and practices to create sustainable, long-term economic prosperity.

Spurring the emergence of the New Paradigm is that index-based and other "passive" funds, with their longer time horizons for investing in particular companies, continued to grow in size and importance into 2019. Of the $10 trillion in AUM by investors in publicly traded equities, the split between passive and active is almost 50%/50%, a sea change from two decades earlier when passively held assets represented only 6% of a much smaller AUM pool. Over the course of 2018, over $400 billion flowed into U.S. passively managed funds, a decrease from the over $500 billion that poured into such investments in 2017. Conversely, 2018 saw investors pull over $150 billion from actively managed funds, increasing the pressure faced by the portfolio managers to show

[1] MARTIN LIPTON, INTERNATIONAL BUSINESS COUNCIL OF THE WORLD ECONOMIC FORUM, THE NEW PARADIGM: A ROADMAP FOR AN IMPLICIT CORPORATE GOVERNANCE PARTNERSHIP BETWEEN CORPORATIONS AND INVESTORS TO ACHIEVE SUSTAINABLE LONG-TERM INVESTMENT AND GROWTH (2016), *available at* http://www.wlrk.com/docs/thenewparadigm.pdf.

near term returns and outperformance. Many of the companies that comprise the S&P 500 now have Vanguard, BlackRock and State Street in the "top five" of their shareholder register, with the broader ownership base being primarily institutional. These changes underscore the importance of index fund support and the risks companies face if they take such support for granted. The broader evolving trend is not only an increase in the frequency and depth of engagement, but also a more fundamental emphasis on the roles and responsibilities of both companies and shareholders in facilitating thoughtful conversations instead of reflexive, off-the-shelf mandates on corporate governance issues, and cultivating long-term relationships that have the potential to curb short-term pressures in the market. In short, shareholder engagement is no longer limited to the "proxy season" or special situations, and has become a regular, ongoing initiative of corporate governance and investor relations teams at public companies, with direct engagement with portfolio managers and governance professionals of key shareholders increasingly being a year-round effort.

a. New Tactics

Activists have also become more sophisticated, hiring investment bankers and other seasoned advisors to draft "white papers," aggressively using social media and other public relations techniques, consulting behind the scenes with traditional long-only investment managers and institutional shareholders, nominating director candidates with executive and industry expertise, invoking statutory rights to obtain a company's non-public "books and records" for use in a proxy fight, deploying precatory shareholder proposals (such as Greenlight's dual-class proposal at GM, which was defeated) and being willing to exploit vulnerabilities by using special meeting rights and acting by written consent. Special economic arrangements among hedge funds continue to appear from time to time, as have so-called "golden-leash" arrangements between activists and their director nominees that periodically appear. In July 2016, the SEC approved a change to Nasdaq's listing rules that requires Nasdaq-listed companies to disclose these "golden-leash" arrangements, with some exceptions.[2] Most companies will now exercise self-help through carefully drafted bylaw provisions that address undisclosed voting commitments and compensation arrangements between activist funds and their director nominees. Activists have also used majority voting to further their campaigns. For example, H Partners Management, a 10% shareholder of Tempur Sealy, waged a successful economic-based campaign, after the nomination deadline for shareholder director nominations had passed, to get shareholders to withhold votes from three incumbent directors, leading to the resignation of targeted directors.

The Court of Chancery's late-2017 ruling in *Lavin* v. *West Corp.* may also encourage activists to make greater use of the statutory books and records inspection rights of Section 220 of the Delaware General Corporation Law (the "DGCL") in connection with

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[2] *See* Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 2, to Require Listed Companies to Publicly Disclose Compensation or Other Payments by Third Parties to Board of Director's Members or Nominees, Release No. 34-78223; File No. SR-NASDAQ-2016-013 (July 1, 2016).

proposed M&A activity.[3] There, the Court confirmed that stockholders may use their Section 220 rights to investigate suspected wrongdoing by the board in agreeing to a sale of the company, ruled that such requests are subject to the same stockholder friendly standard that applies in other contexts (any proper purpose reasonably related to the stockholder's interest as a stockholder), and held that fully informed stockholder approval of the transaction will not extinguish a stockholder's right to demand inspection of books and records related to the transaction. At least some activists have already made use of this tool in their campaigns to scuttle deals, such as Carl Icahn's books and record inspection demand of SandRidge Energy for documents relating to its proposed merger with Bonanza Creek Energy, Inc.

b. M&A Activism

Activism pushing for a sale of the company or some other form of "strategic review" or evaluation of "strategic alternatives" is increasing. In 2018, 33% of activist campaigns were related to M&A. There are generally three types of M&A activism: campaigns to sell the target company (which accounted for approximately 41% of M&A activism campaigns in 2018), campaigns aimed at breaking up a target company or having the target company divest a non-core business line (which accounted for approximately 28% of M&A activism campaigns in 2018) and campaigns that attempt to scuttle or improve an existing deal (which accounted for approximately 30% of M&A activism campaigns in 2018). Deal activists may have little to lose, particularly when they exploit inherent deal uncertainty to buy the target's stock at a discount to the deal price and agitate for additional consideration. Even if there is no bump in transaction consideration for all shareholders, activists may still seek to profit from hold-up tactics and extract private benefits that may come at the expense of other shareholders. Just as U.S. investors have exported general activism abroad, U.S. hedge funds increasingly consider agitating against non-U.S. deals, often leveraging the idiosyncrasies of local laws to seek special benefits while deploying other U.S.-style tactics. Elliott Management's activism and hold-out for a higher purchase price in Qualcomm's tender offer for NXP (Netherlands) is one recent prominent example.

However, the Court of Chancery in 2018 underscored that activists who join boards must adhere to the same fiduciary duties as other directors and must place the interests of the company and all stockholders above any personal, fund-specific or short-sighted interests, including in the context of M&A activism. In *In re PLX Technology Inc. Stockholders Litigation*, the Court of Chancery found that directors nominated by an activist hedge fund and elected following a proxy contest breached their fiduciary duty by improperly taking control of a sale of the company. The Court of Chancery noted that the hedge fund and its principal had a divergent interest in achieving quick profits by orchestrating a near-term sale.

[3] *Lavin* v. *West Corp.*, C.A. No. 2017-0547-JRS, 2017 WL 6728702 (Del. Ch. Dec. 29, 2017).

2. Governance Activism

Companies face a rapidly evolving corporate governance landscape defined by heightened scrutiny of a company's articulation of long-term strategies, board composition and overall governance *bona fides*, frequent implementation by companies of shareholder proposals and increasing direct shareholder engagement. As many companies have, in recent years, taken steps such as instituting majority voting (now almost universal among large companies), declassifying their boards of directors, eliminating takeover defenses, granting special meeting rights and, in certain cases, separating the roles of chairman and chief executive officer, there are fewer targets for shareholder proposals on such topics.

One of the explanations for increasing shareholder support of governance changes is voting by institutional shareholders in accordance with recommendations of shareholder advisory services, such as ISS and Glass Lewis. These shareholder advisory services publish proxy voting guides setting forth voting policies on a variety of common issues that are frequent subjects of shareholder proposals. By outsourcing judgment to consultants or otherwise adopting blanket voting policies on various governance issues, institutional shareholders increasingly do not review individual shareholder proposals on a company-by-company basis. As a result, many shareholder votes may unfortunately be preordained by a blanket voting policy that is applied to all companies without reference to the particulars of a given company's performance or governance fundamentals. Notable exceptions to this general trend involve some large funds, such as BlackRock, State Street and Vanguard, which have formed their own large internal governance departments and have been more proactive in engaging directly with companies. Actively managed funds are also building out their own dedicated governance and ESG-focused teams as well, even as portfolio managers remain the most important audience at such investors.

Proxy advisory firms themselves have become subject to heightened scrutiny. The Corporate Governance Reform and Transparency Act, which passed the House of Representatives in November 2017 and was the subject of a hearing held by the Senate banking committee in June 2018, would require proxy advisors such as ISS and Glass Lewis to register with the SEC, file an annual report and make publicly available their methodology for the formulation of voting recommendations. The Corporate Governance Fairness Act, which was introduced in the Senate in November 2018, would require proxy advisors to register with the SEC under the Investment Advisers Act of 1940. The SEC has also signaled a review of proxy advisor regulation, hosting a roundtable on the proxy process in November 2018.

Proxy Access. Over the past decade, expanding shareholders' ability to nominate their own director candidates by permitting them to do so using the company's own proxy statement and proxy card rather than using their own proxy materials has been a fertile area for activism, discussion, rule-making and litigation. Proxy access efforts by shareholders continued into the 2018 proxy season, and by early 2019, approximately 524 public companies had implemented proxy access, often through negotiations with shareholder proponents or even proactively in advance of receiving a shareholder proposal. The proxy access "market" has now appeared to coalesce around "3/3/20/20" headline formulations

requiring eligible shareholders to have continuously owned at least 3% of the company's outstanding stock for at least three years, limiting the maximum number of proxy access nominees to 20% of the board with appropriate crediting of previously elected nominees and permitting reasonable levels of aggregation and grouping (*e.g.*, up to 20 shareholders) to meet the 3% threshold; treatment of other terms varies by company.

Universal Proxy Card Proposal. In October 2016, the SEC proposed amendments to the proxy rules that, if adopted, would mandate "universal" proxy cards in contested director elections and impose new nominee notification and proxy filing deadlines. Under the proposed rules, shareholders voting in a contested election would receive a single "universal" proxy card presenting both company and dissident nominees, enabling them to "mix and match." As of the writing of this outline, the outcome of the proposal has not been determined. SandRidge Energy included its five nominees along with seven nominees selected by Carl Icahn in its June 2018 proxy card, marking the first time that a U.S. corporation used a universal proxy card (although Carl Icahn ultimately won control of the SandRidge board).

Structural Provisions. Shareholder proposals requesting companies to repeal staggered boards continue to be popular, and such proposals have passed 82.4% of the time since 2005 at S&P 500 companies. However, some institutional investors are evaluating whether "one-size-fits-all" objections to classified boards have been overdone, especially in light of recent, well-regarded econometric studies showing that classified boards can promote long-term value creation. At year-end 2018, approximately 11.2% of S&P 500 companies had a staggered board, according to SharkRepellent figures, down from 47% as of 2005. Staggered boards are more prevalent among smaller companies, with 28.7% of the companies in the S&P 1500 having a staggered board at the end of 2018. As distinct from rights plans, a company that gives up its staggered board cannot regain a staggered board when a takeover threat materializes because it cannot be adopted unilaterally without shareholder approval, which would be difficult to obtain.

Over the past decade, governance activists have sponsored precatory resolutions seeking repeal of or a shareholder vote on shareholder rights plans, also known as "poison pills." One result of this activism has been a dramatic decline in the proportion of large public companies that have rights plans in place, and an increase in the number of companies choosing instead to have "on-the-shelf" rights plans ready to be adopted promptly following a specific takeover threat. According to SharkRepellent, at year-end 2018, only 1.0% of S&P 500 companies had a shareholder rights plan in effect, down from approximately 45% as recently as the end of 2005. Importantly, unlike a staggered board, a company can adopt a rights plan quickly if a hostile or unsolicited activist situation develops. However, as discussed further in Section VI.A, companies should be aware of ISS proxy voting policy guidelines regarding recommendations with respect to directors of companies that adopt rights plans.

Additionally, governance advisors have increased their focus on charter and bylaw provisions adopted by newly public companies. ISS has issued voting guidelines under

which it generally will make adverse recommendations for directors at the first shareholder meeting of a newly public company if that company has bylaw or charter provisions that are "materially adverse to shareholder rights." Unless an adverse provision is reversed or submitted to a vote of public shareholders, ISS will make voting recommendations on a case-by-case basis on director nominees in subsequent years. Glass Lewis' guidelines provide for a one-year grace period for companies that have recently completed an IPO in which Glass Lewis refrains from issuing voting recommendations on the basis of corporate governance best practices, except in egregious cases. However, Glass Lewis will consider recommending that stockholders vote against the members of the board who served when an anti-takeover provision such as a shareholder rights plan or a classified board was adopted if the board (i) did not also commit to submit such provision to a shareholder vote at the company's first shareholder meeting following the IPO or (ii) did not provide a sound rationale or sunset provision for adopting such provision. In addition, shareholder activists have pressured companies to remove, or agree not to include, several anti-takeover defenses in spin-off companies' governance documents.

Action by Written Consent. Governance activists have been seeking to increase the number of companies that may be subject to consent solicitations. As of early 2019, approximately 66.2% of S&P 500 companies prohibit shareholder action by written consent. During 2005-2009, only one Rule 14a-8 shareholder proposal was reported to have sought to allow or ease the ability of shareholders to act by written consent. From 2010 to 2018, however, there were 236 such proposals (approximately 18% of which passed). Hostile bidders and activist hedge funds have effectively used the written consent method to facilitate their campaigns, and companies with provisions permitting written consent should carefully consider what safeguards on the written consent process they can legally and appropriately put in place.

Special Meetings. Institutional shareholders have also been pushing for the right of shareholders to call special meetings in between annual meetings, and shareholder proposals seeking such a right can generally be expected to receive significant support, depending on the specific threshold proposed by the shareholder and the company's governance profile. As of early 2019, over 60% of S&P 500 companies permit shareholders to call special meetings in between annual meetings. Among the companies that permit shareholders to call special meetings, there remains significant variation with respect to the minimum threshold required to call a special meeting and as to the procedural requirements and substantive limitations on the exercise of this right. Economic activists and hostile bidders have been able to use the special meeting right to great effect to increase pressure on target boards, including by seeking to remove directors or submit precatory economic proposals. Care should be taken in drafting charter or bylaw provisions relating to special meeting rights to ensure that protections are in place to minimize abuse while avoiding subjecting institutional shareholders who wish to support the call of a special meeting to unduly onerous and unnecessary procedural requirements. Companies should also be thoughtful in deciding how to respond to shareholder proposals seeking to reduce existing meeting thresholds, including whether or not to seek exclusion of the proposal by putting forward a company-styled ratification proposal.

Environmental, Social and Governance ("ESG"). Until fairly recently, ESG-related proxy proposals rarely received significant shareholder support or attention. However, in the 2018 proxy season, the two most common shareholder proposal topics related to social (202 proposals) and environmental (139 proposals, including 72 on climate change). Companies are increasingly expected to integrate relevant sustainability and ESG matters into strategic and operational planning and communicate on these subjects effectively. Sharing sustainability information, corporate responsibility initiatives and progress publicly on the company's website and bringing them to the attention of investors who prioritize these issues will become increasingly significant actions. While the exact direction of ESG-related activism is not easily discernible, companies must be prepared for wide swaths of their shareholders and other stakeholders to engage with them on such issues. Some activist hedge funds are beginning to invoke ESG-related themes in their investments to try to appeal to certain institutional investors, such as JANA Partners' fundraising efforts for a new "social impact" fund, which secured early publicity when JANA Partners teamed up with CalSTRS on a platform of encouraging Apple to provide more disclosures regarding parental controls and tools for managing use of technology by children, teenagers and young adults. Trillium Asset Management filed a first-of-its-kind proposal at Nike urging the board to improve oversight of workplace sexual harassment and to improve gender diversity and pay disparity, which it ultimately withdrew following a commitment by Nike to evaluate its request and meet quarterly to discuss the results.

3. Debt Activism

There has recently been a rise in "debt default activism," where investors purchase debt on the theory that a borrower is already in default, and then actively seek to enforce that default in a manner by which they stand to profit. When debt prices decline, default activists can more easily buy debt at a discount and then seek to profit by demanding the debt be repaid (in some cases with premium) as a result of an alleged default. Market volatility also drives expansion of the credit default swap ("CDS") market, which can be jet fuel in the hands of a default activist. CDS contracts pay off when the underlying borrower defaults on its debt. While CDS usually serve important *bona fide* hedging purposes, a default activist can buy CDS, assert the occurrence of a default (often on the grounds of a complicated and years-old transaction), and seek to profit from the resulting chaos such assertion creates.

Companies with debt trading below par should stay particularly alert to the threat of default activism, just as companies that have endured short-term stock slumps should be wary of shareholder activism. For a borrower that is actively confronted by a default activist, it is critical to swiftly assemble a team of executives and advisors to lead the response, communicate closely with traditional "long-only" debt investors, and develop a comprehensive strategy for addressing the threat in real time.