

**MORRISON
FOERSTER**

SHAREHOLDER ACTIVISM

What is Shareholder Activism?

- Shareholder activism refers to a range of activities undertaken by shareholders for the purpose of effecting change at the corporations that they own.
- Shareholder activism activities range from asking companies to present proposals at annual meetings regarding environmental, social and governance matters to seeking to cause a change of control.
- A wide spectrum of investors engage in shareholder activism, including individuals, hedge funds, pension funds and other institutional investors.

The Legal Framework for Activism

Director Duties

- A director of a Maryland corporation must perform his or her duties:
 - In good faith;
 - In a manner the trustee reasonably believes to be in the best interests of the company; and
 - With the care that an ordinarily prudent person in a like position would use under similar circumstances.

Director Duties

- **Additionally, directors must:**
 - **Subjectively believe that the action taken is in the company's best interests, which belief must be objectively reasonable.**
 - **Exercise his or her own judgment as to the best interests of the company.**
 - **Inform themselves of all reasonably available information that is material to their decision.**
- **Whenever confronted with shareholder activism, directors must consider their duties to the corporation.**

Federal Securities Laws

- In addition to state corporation laws, US federal securities laws must also be considered.
- The federal proxy rules provide for a mechanism by which shareholders are able to vote by proxy on matters raised by both shareholders and companies at annual and special meetings.
- SEC Rule 14a-8 provides a means by which a shareholder meeting certain eligibility requirements can have shareholder proposal included in a company's proxy statement.
- Exchange Act Section 14A requires that public companies hold an advisory vote on executive compensation.

The Legal Framework for Activism

Shareholder Proposals

Securities Exchange Act of 1934

Rule 14a-8

Shareholder Proposals

- Exchange Act Rule 14a-8.
- Shareholder Eligibility – Rule 14a-8(b)(1) –
 - Own \$2000 or 1% for one year;
 - Own continuously for at least one year by the date proposal is submitted; and
 - Must continue to hold those securities through the date of the meeting.
- Number – Rule 14a-8(c) –
 - One proposal per shareholder.

Shareholder Proposals

- Length of proposal and supporting statement – Rule 14a-8(d) –
 - No more than 500 words.
- Timing – Rule 14a-8(e) –
 - Proposal must be submitted not less than 120 calendar days before the date of the proxy statement for the prior year’s annual meeting.
- Presentation of proposal at annual meeting – Rule 14a-8(h) –
 - Proponent or representative must attend annual meeting and present proposal.

Shareholder Proposals

- Substantive Matters – Rule 14a-8(i) –
 - The issuer may exclude a proposal if its falls into one or more of 13 categories.
- Rule 14a-8(i) Categories –
 - (1) *Improper under state law*: The proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the issuer's organization.
 - (2) *Violation of law*: The proposal would, if implemented, cause the issuer to violate any state, federal, or foreign law to which it is subject.
 - (3) *Violation of proxy rules*: The proposal or supporting statement is contrary to any of the Commission's proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials.

Shareholder Proposals

- Rule 14a-8(i) Categories (Continued) –
 - (4) *Personal grievance or special interest*: The proposal relates to the redress of a personal claim or grievance against the issuer or any other person, or if it is designed to result in a benefit to the proponent, or to further a personal interest, which is not shared by the other shareholders at large.
 - (5) *Relevance*: The proposal relates to operations which account for less than 5 percent of the issuer's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the issuer's business.
 - (6) *Absence of power/authority*: The issuer would lack the power or authority to implement the proposal.
 - (7) *Management functions*: The proposal deals with a matter relating to the issuer's ordinary business operations.

Shareholder Proposals

- Rule 14a-8(i) Categories (Continued) –
 - (8) *Relates to election*: The proposal –
 - Would disqualify a nominee who is standing for election;
 - Would remove a director from office before his or her term expired;
 - Questions the competence, business judgment, or character of one or more nominees or directors;
 - Seeks to include a specific individual in the issuer’s proxy materials for election to the board of directors; or
 - Otherwise could affect the outcome of the upcoming election of directors.

NOTE – Rule 14a-8(i) (8) Does NOT permit exclusion of “proxy access” proposals.

Shareholder Proposals

- Rule 14a-8(i) Categories (Continued) –
 - (9) *Conflicts with an issuer proposal*: The proposal directly conflicts with one of the issuer's own proposals to be submitted to shareholders at the same meeting.

NOTE – SEC is reconsidering Rule 14a-8(i)(9) and is not currently taking no-action positions.

- (10) *Substantially implemented*: The issuer has already substantially implemented the proposal;
- (11) *Duplication*: The proposal substantially duplicates another proposal previously submitted to the issuer by another proponent that will be included in the issuer's proxy materials for the same meeting;

Shareholder Proposals

- Rule 14a-8(i) Categories (Continued) –
 - (12) *Resubmissions*: The proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the issuer’s proxy materials within the preceding 5 calendar years and the last time it was included the proposal received:
 - Less than 3% if proposed once in last 5 calendar years;
 - Less than 10% on its last submission if proposed three times or more within the last 5 calendar years.
 - Less than 6% on its last submission if proposed twice within the last 5 calendar years; or

NOTE – In these situations, the issuer may exclude the proposal it from its proxy materials for any meeting held within 3 calendar years of the last time it was included.

- (13) *Specific amount of dividends*: The proposal relates to specific amounts of cash or stock dividends.

Shareholder Proposals

- **Burden of Proof – Rule 14a-8(g) –**
 - The issuer has the burden to demonstrate an ability to exclude a proposal.
- **Issuer obligation to submit notice to the SEC – Rule 14a-8(j) –**
 - Notice demonstrating basis to exclude must be presented to the SEC no later than 80 calendar days before the issuer mails its proxy statement for the annual meeting.
 - Issuer must provide a copy of the notice to the proponent.
 - If the basis relies on state or foreign law, the notice must include an opinion of counsel.

The Profile of Activist Investors

Hedge Fund Activism Is Increasing



Notable Activist Funds

- Appaloosa Management
- Barrington Capital
- Bulldog Investors
- Cannell Capital
- Chapman Capital
- Elliott Management* (*Paul Singer*)
- ESL Investments
- Greenlight Capital* (*David Einhorn*)
- Highland Capital
- Icahn Partners* (*Carl Icahn*)
- JANA Partners* (*Barry Rosenstein*)
- Knight Vinke
- Perry Capital
- Pershing Square Capital* (*William Ackman*)
- Relational Investors* (*Ralph Whitworth*)
- Schoenfeld Asset Management
- Starboard Value* (*Jeffrey Smith*)
- Steel Partners
- Stilwell Value
- Third Point* (*Daniel Loeb*)
- TPG-Axon
- Tracinda (*Kirk Kerkorian*)
- Trian Partners* (*Nelson Peltz*)
- ValueAct Capital* (*Jeffrey Ubben*)

* Largest funds

Traditional Investors As Activists

- Long-term institutional investors have embraced activist tactics
 - Fidelity, CalSTRS, CalPERS, T. Rowe Price and BlackRock
 - “Shareholder democracy” movement has made activism more acceptable
 - Many institutional investors also invest in activist funds
- Still rare for institutional investors to lead an activist campaign
- More common for institutional investors to publicly support activist campaigns
- Non-public institutional investor support of activist campaigns is now quite commonplace

Companies can no longer assume the support of their long-term institutional shareholders.

No Company Is “Too Big”

Select companies with market caps > \$10BB with recent hedge fund activism

 Agrium



CANADIAN
PACIFIC
RAILWAY



Microsoft®



YAHOO!



Forest Laboratories, Inc.



P&G

ebay™



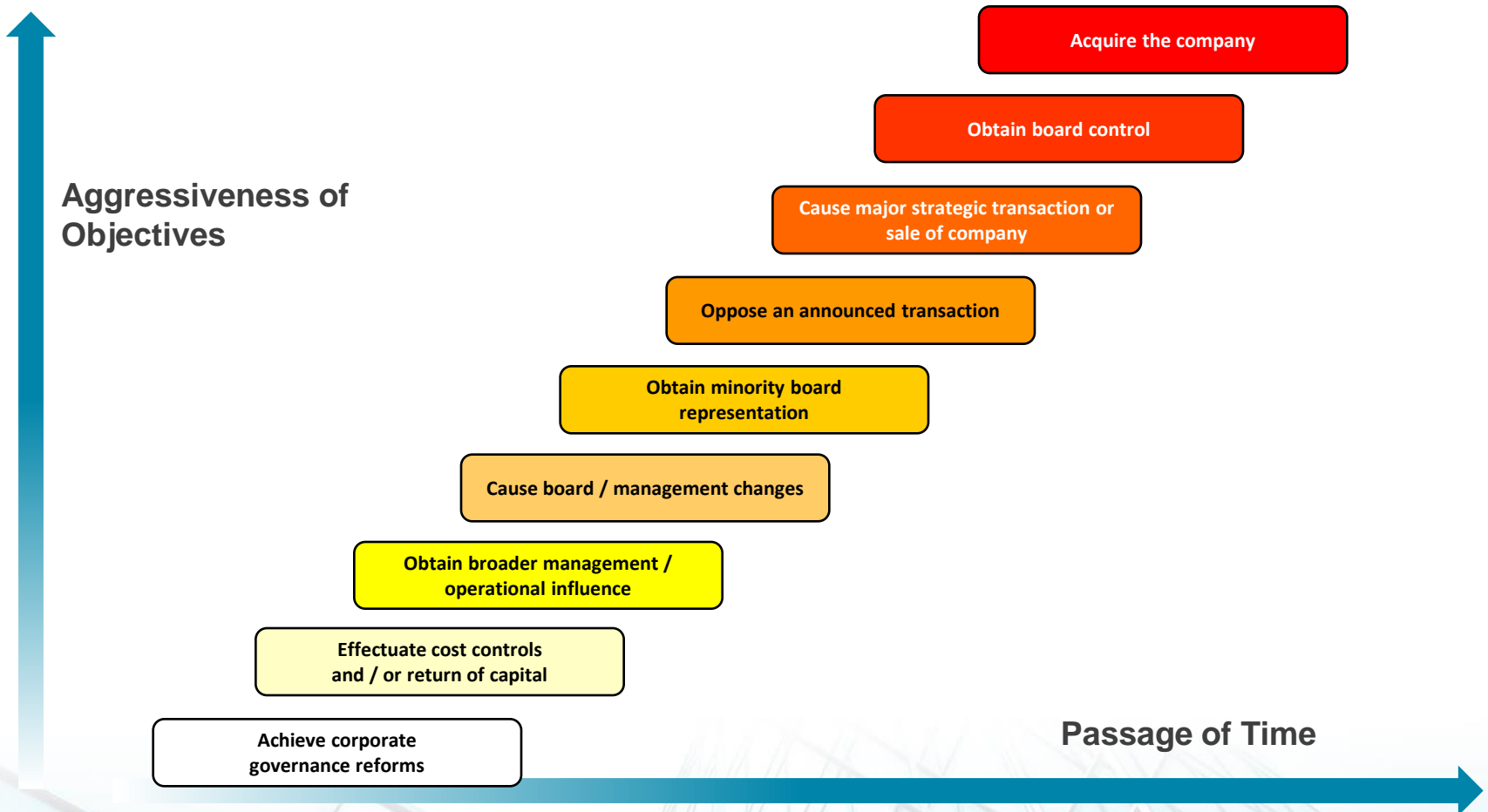
MOTOROLA

Although most activist campaigns target small and mid-sized companies, no company is too large to be subject to hedge fund activism.

Impact of Proxy Advisors Services

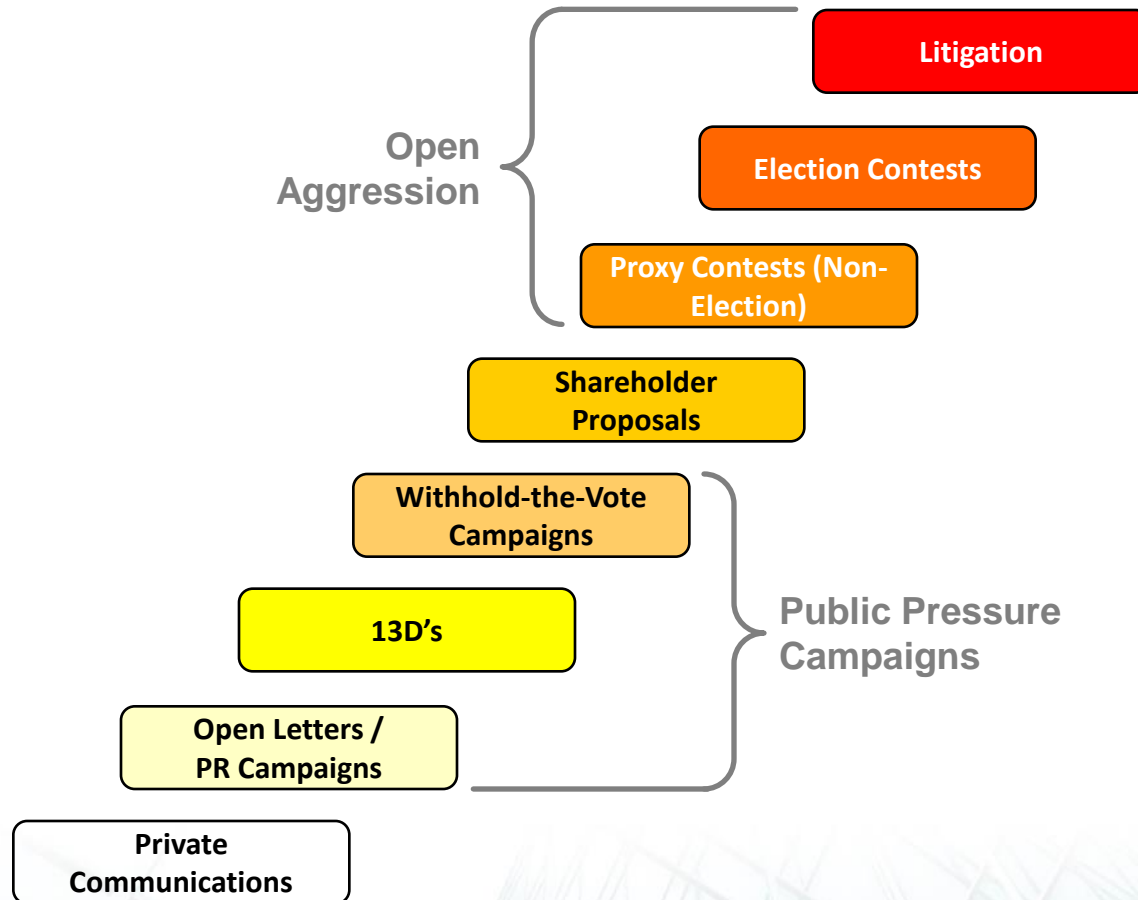
- Proxy advisory services exert significant influence on stockholder voting and governance
- ***Institutional Shareholder Services (ISS)*** — *the* largest and most influential advisory firm
 - Can directly influence the vote of 25% or more of shares outstanding
 - Most institutional investors review ISS research in some capacity
 - ISS voting policies are transparent, for the most part
 - ISS staff is willing to engage with corporate issuers in many instances
 - ISS provides services to issuers, as well as to institutional investor clients
- ***Glass Lewis & Co.*** — the largest competitor to ISS
 - Significantly less influential than ISS, given a more limited client base
 - Does not provide services to issuers
 - Is willing to engage with companies only outside of the solicitation process
- **Egan Jones Proxy Services** — much smaller and less influential than ISS and Glass Lewis
- SEC staff recently published guidance on the activities of proxy advisory services under existing SEC rules

Activist Campaign Objectives



Objectives can, and often do, change over time as activist demands are not met.

The Range of Hedge Fund Tactics



“Open Aggression” tactics are much more costly and, therefore, not as common. However, success of aggressive actions has made them popular.

Tactics — Derivatives / Empty Voting

- Opportunistic investors can adjust their exposure to the issuer in order to decouple their economic and voting interests
 - Contra hedge can distort incentive to vote in a manner that benefits all shareholders
- Forcing activist disclosure is critical, so a target can attack the investor's "empty vote"
 - Schedule 13D requires disclosure of contracts concerning "any securities of the issuer," which can include derivatives, but often derivatives do not trigger Schedule 13D filing obligation
- Advance notice bylaw provision can require stockholders to disclose their derivative positions (and more) before submitting nominations or proposals for a stockholder meeting
- Recent rights plans also attempt to address the issue of derivative ownership
 - Include derivative positions in the definition of "Beneficial Ownership"
 - Aggregating Beneficial Ownership of persons "acting in concert" (aka wolf-packs) has faded due to concerns regarding the validity of such provisions under state law

Tactics — Short Slates

- Activist may solicit proxies for a minority of the board of directors
 - Proxy rules allow dissident to round out slate by including nominees named in the company's proxy without obtaining their consent
- Continue to be popular
 - More likely to be supported by institutional shareholders than control slates
 - Often supported by ISS and other proxy advisory firms and, if supported, often successful
 - Allows dissident to exercise influence without having to run the company
 - Allows dissident to leave certain incumbents on the board and support nominees of another dissident—dissident can round out its slate with nominees of the company or another dissident
 - Useful when election of a control slate would trigger change-of-control provisions in company debt agreements, severance agreements and other material contracts
 - However, activists are seeking control of boards more frequently than in the recent past, and getting surprisingly strong support
 - Notwithstanding strong activist pressure with backing from ISS, successful defense against short slate campaign still possible (see, e.g., 2012 AOL proxy contest)

Tactics — Proxy Access

- “Proxy access” describes when a qualifying shareholder or group of qualifying shareholders has the ability to nominate one or more directors through the company’s proxy statement.
- The SEC adopted a mandatory proxy access rule in August 2010, which was vacated by the United States Court of Appeals for the DC Circuit in July 2011; the SEC did not appeal or seek re-hearing of the court’s decision.
- The SEC adopted amendments to its shareholder proposal rule (Rule 14a-8) to pave the way for “private ordering” of proxy access through the use of the shareholder proposal process.
- There are a number of options available under Rule 14a-8 for a company that receives a proxy access shareholder proposal:
 - Argue that the proposal is contrary to the proxy rules under Rule 14a-8(i)(3), *i.e.*, the resolution contained in the proposal is inherently vague or indefinite
 - Propose a company proxy access proposal that conflicts with the shareholder proposal under Rule 14a-8(i)(9), although the SEC has recently stopped expressing a view on 14a-8(i)(9)
 - Adopt a proxy access bylaw amendment and argue that proxy access has been “substantially implemented” under Rule 14a-8(i)(10)
 - Argue other substantive and procedural bases for exclusion, as applicable
- Many companies continue to take a “wait and see” approach to proxy access; however, some large companies – *e.g.*, Hewlett-Packard, Verizon and McKesson – have adopted, or announced their intention to propose, a proxy access bylaw.

Countering Activists — Investor Relations

- Regularly communicate with and court large shareholders (subject to Reg FD)
- Constantly monitor statements by shareholders and financial press
- Focus on accumulations of shares and movements of significant positions, particularly involving activists that often work together
- Review ISS corporate governance analysis for potential issues
- Make sure the company has a clear communications policy and speaks with one voice
- Anticipate activist issues and address them proactively:
 - Address Board composition issues
 - Formulate plans for cash and articulate them to the market
 - Consider divestiture (or other alternatives) for non-core, underperforming or unused assets

Activists typically take minority positions and need the support of other shareholders to succeed.

Countering Activists — Readiness

- Monitor the activity of activist investors, particularly in the technology sector, to better anticipate any potential threats
- Different activists employ different strategies and have different risk tolerances
 - Know the activists you're dealing with and craft your strategy accordingly
- Have an advisory team ready, including key management, investment bankers, inside and outside legal counsel, a proxy solicitor, and a financial public relations firm
- Respond to any activist approach promptly
- With activism increasing, periodically assess the vulnerability of the Company to hedge fund activism
 - Evaluate the Company's corporate governance profile and bylaws, seeking to identify any potential areas of weakness
 - Evaluate the Company's strategy, and be prepared to defend that strategy in the event of a challenge by an activist investor
 - Based on the Company's profile, develop a response plan that can be implemented if the Company is targeted in the future

Countering Activists — Readiness

- Shareholder engagement should be a centralized and coordinated effort
 - Board members can be an important part of shareholder engagement but it should be coordinated through the company
 - All requests to speak with board members should be referred to the company
 - Essential to speak with one voice
 - Remember that communications with shareholders are regulated—for example, Reg FD and proxy communication rules
- Shareholder activism may lead to litigation
 - Emails and other written communications may be taken out of context; consider oral communications when appropriate

Case Studies

Case Study — Apple Inc. (Return-of-Capital Objective)

- At the end of 2012, Apple had over \$130 billion in cash and had announced plans to return some cash to shareholders through dividends and buybacks but many investors thought it was insufficient.
- In 2013, Greenlight Capital proposed that Apple issue preferred stock to shareholders that would provide shareholders with higher dividend income over time.
- Apple responded by proposing to amend its Articles of Incorporation to remove preferred stock authority. Apple combined the proposal with other amendments to the Articles.
- Greenlight sued Apple, alleging improper “bundling” of the amendment proposals. The court agreed with Greenlight, and Apple withdrew the proposal from the annual 2013 meeting agenda.
- In 2013-14, Carl Icahn pushed for a larger stock buyback. He submitted a proposal for Apple’s Annual Meeting for a non-binding shareholder vote on a \$50 billion buy back but dropped proposal due to lack of support.

Case Study — eBay Inc. (Spin-off Objective)

- January 2014, eBay announces receipt of notice from Icahn of
 - (1) a non-binding proposal to spin-off eBay's PayPal business and
 - (2) nomination of two Icahn nominees for the eBay board.
 - eBay / PayPal release materials arguing that eBay and PayPal are more valuable together
- February 2014, Icahn sends open letter to eBay shareholders stating there is “complete disregard for accountability at eBay” and directors should resign “out of pure decency or sheer embarrassment.” The letter asks shareholders to approve Icahn's nominees and the spin-off proposal.
- February / March 2014, Substantial back and forth between eBay and Icahn regarding Icahn's allegations. Icahn remained very critical of certain Board members (in part to garner support for his nominees).
- March 2014, eBay and Icahn each file proxy materials in support of their nominees / positions on Icahn's spin-off proposal.
- April 2014, eBay announces settlement with Icahn that results in Icahn's withdrawal of the proposal and his nominees, and eBay's addition of another independent director to the Board (not one of Icahn's nominees).

Case Study — Microsoft (Strategic Direction Objective)

- April 2013, ValueAct Capital disclosed approximate \$2 billion stake in Microsoft
- ValueAct operates less publicly than other activists (such as Icahn, Ackman and Einhorn)
 - ValueAct supported long-term investment in Microsoft, believing it was undervalued
 - ValueAct presented its views to management, which included a return of capital to shareholders and a strategic focus on core business software and Internet-based cloud services and less emphasis on consumer products
 - ValueAct apparently left open the possibility of a proxy contest to add a board member(s)
- August 2013, Microsoft announces agreement with ValueAct under which:
 - ValueAct was awarded a board seat in the first quarter of 2014
 - ValueAct agreed not to pursue a proxy contest or extraordinary transaction, and agreed to other restrictions on its activities
- The agreement was announced on deadline for shareholder nominations / proposals and one week after Ballmer announced his retirement (though said not to be related)

Case Study — Allergan Inc. (Acquisition Objective)

Valeant, Pershing bid for Allergan

- February 2014, Pershing Square and Valeant Pharmaceuticals create a joint fund and accumulate shares of to acquire Allergan. Current holdings are 9.7% of outstanding Allergan shares.
- April 2014, Valeant offers \$48.30 in cash + 0.83 shares of Valeant stock for each Allergan share, Allergan adopts a poison pill to expire in 1 year.
- May 12, 2014, Allergan rejects Valeant's offer.
- May 13, 2014, Pershing files a proxy statement with the SEC announcing a meeting of Allergan stockholders to vote on a non-binding resolution requesting the Allergan board to engage in good faith discussions with Valeant regarding Valeant's proposal.
- May 28, 2014, Valeant offers \$58.30 in cash + 0.83 shares of Valeant stock for each Allergan share.
- May 30, 2014, Without waiting for a reply from Allergan, Valeant revises its offer to \$72 in cash + 0.83 shares of Valeant stock for each Allergan share.
- June 2, 2014, Pershing and Valeant take their bid to Allergan's shareholders by requesting, in an SEC filing, a Special Meeting for the purpose of removing a majority of the Allergan board.

Allergan share price = \$169.22 on 6/30/2014 (NYSE:AGN)