SPECIAL REPORT

THE REBIRTH OF INVESTOR ACTIVISM

FROM RAIDERS TO RESCUERS, A NEW GENERATION

BEST PRACTICES OF THE BEST DEALMAKERS

2015

Featuring

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With An Introduction By

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EXECUTIVE SUMMARY

Amid a general resurgence in M&A activity in the United States in recent years, the headlines have been filled with stories about activist investors pressing companies, their boards and management – from large to microcap in size – to produce better returns for the shareholders – either through strategic changes in management and direction, or through financial transactions like dividends, buybacks or sales of all or part of the companies.

These new activists are a far cry from the previous generation – the "corporate raiders" and "greenmailers" depicted in unflattering terms in books like "Barbarians at the Gate" and movies like "Wall Street." These activists, most agree, are more prone to quiet persuasion. By and large they work directly with boards and management, and out of the headlines. It may surprise many that the activists target microcap companies more than large caps, although large cap battles grab media attention and may lead to a perception that activists are more vocal than ever.

There is no dispute that they are having an impact. Studies and surveys document the success of activists in improving returns to shareholders. Yet critics say the "jury is still out" on the long-term effects of this new activist trend, and some worry that employees, customers, industries and communities are harmed in the process.

For this Special Report, the M&A Advisor interviewed participants in the activist segment of the M&A industry. Our interviews were with lawyers, advisors, data providers, communicators – and an activist investor with three decades experience as a venture capitalist and hedge fund manager who has joined many boards of directors of the companies he has invested in. They don't agree about everything but their consensus view is that activism is here to stay.

'One simply cannot say activists are "good" or "bad," constructive or destructive forces. They are all of the above and other things as well.' ~ Marshall Sonenshine

Introduction by Marshall Sonenshine

Some years ago the idea of shareholder activism seemed non mainstream, akin to ambulance chasing. In the era of greenmail, activism was analogized to corporate extortion. That has changed, such that today shareholder activism broadly is part of the corporate finance landscape alongside companies, boards, bankers and investors. Like hostile takeover activity, which similarly was once thought of as impolitic or down market corporate behavior, activism has gone from often dodgy to generally mainstream.

The activist community includes many flavors just as all professional communities within financial markets do, whether banking, law, board, management or investor. One simply cannot say activists are "good" or "bad," constructive or destructive forces. They are all of the above and other things as well.

For the seasoned deal maker, activists can be friend or foe. In the closely watched 2014 $25 billion leveraged buyout of Dell Computer, the activist constituency led by Carl Icahn was viewed as foe to the group of participants led by Michael Dell and Silver Lake Partners, who had convinced the Dell board that a premium to even a weak stock was better than no deal at all. The announced deal aligned the board with the management led buyout group in advocating that shareholders vote in favor of a $25 billion buyout by the founder of a company that had once been valued at over $150 billion and had completed some $13 billion in acquisitions in the years leading up to the buyout.[1]

A deeper look into the curious case of Dell, however, reveals that activists had an important role in instigating the deal: Southeastern Management, which for most of the struggle seemed to be aligned with Icahn, had actually been an early proponent of the very deal process that would lead to the proposed deal, and when the deal ended up in Delaware Chancery Court, Judge Leo Strine took judicial notice of the fact that Southeastern Management had sold

[1] See M. Sonenshine, "The Curious Case of Dell," Columbia University CaseWorks, 2014.

most of its shares to Icahn.[2] Thus, one of the loudest voices against the deal had actually commenced and implicitly supported the deal. This ought not surprise, since deal making, like politics, can align strange bedfellows.

The most blunt activists, Icahn among them, are often infuriatingly prescient. The campaign Icahn waged against the Dell deal had a sufficiently strong case that the deal would be long delayed and approved by an unusually weak shareholder vote of about 65% of the disinterested stockholders. Most public mergers are approved by over 90% (sufficient generally to facilitate a short form merger of the remaining 10%) and many are approved by over 95%. Not Dell. Dell's public stockholders voted less than 2:1 in favor of Michael Dell's buying back the company. In M&A terms, that is broadly similar to a hospitalized boss getting a Get Well card from his employees, who write "Dear Boss, all of us at the office voted 6 to 4 that we wish you a full and speedy recovery."

The coup de grace in Dell would come not only in the weak shareholder vote for the deal but in the subsequent history. A year after Dell closed, a consensus was rapidly building in financial markets that the buyers of Dell were enjoying a huge gain on investment.[3] Icahn may have been shrill, but that does not mean he was wrong.

In the years leading up to the Dell deal, activist funds had proliferated. Funds under management by activist investors had risen from approximately $36 billion in 2009 to over $112 billion in 2014.[4] During that period, Bill Ackman became a public celebrity for his brash maneuvers against companies. In some cases he arguably had some points broadly right – Herbalife indeed appears to have some problems, though Ackman could not always get the market to see that.[5] In other cases he missed the mark by a wide margin, as in JC Penney in which he had pushed the board to retain the wrong CEO, only to make JC Penney's problems worse, leading to his own resignation from the board.[6]

The rise in activism was facilitated in the 1990s by the SEC, which promulgated new shareholder proxy rules that made it easier and cheaper for stockholders to wage proxy fights. In the 2000s, particularly post the Financial Crisis of 2008, the continued growth in activism was driven by the market itself – the demand by public investors for value that corporations

2. See remarks of Judge Leo Strine in High River LP et al vs. Dell Inc et al, (Del. Chancery Court, 2013).
3. See David Carey and Jack Clark, "Dell, Silver Lake Said to Reap 90% Gain a Year After LBO," Bloomberg, 5 Nov. 2014, <http://www.bloomberg.com/news/articles/2014-11-06/dell-silver-lake-said-to-reap-90-gain-a-year-after-lbo>.
4. See "The Activist Revolution: Understanding and navigating a new world of heightened investor scrutiny," J.P. Morgan, Jan. 2015, <https://www.jpmorgan.com/cm/BlobServer/JPMorgan_CorporateFinanceAdvisory_MA_TheActivistRevolution.pdf?blobkey=id&blobwhere=1320667794669&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs>.
5. See Julia La Roche, "Bill Ackman Hasn't Sounded This Confident About Herbalife In A Long Time," Business Insider, 17 Dec. 2014, <http://www.3. com/bill-ackman-on-herbalife-2014-12>.
6. See Emily Glazer et al, "Ackman Moves to Dump Entire Stake in J.C. Penney," The Wall Street Journal, 26 Aug. 2013, <http://www.wsj.com/articles/SB10001424127887324591204579037251135114142>.

too often were not delivering. Hoarding cash became common corporate practice in the long recovery period post 2008, but activists often saw such hoarding as antithetical to shareholder interests and often successfully pressed for special dividends or at least board oversight to seek other forms of value enhancement.[7]

Activist campaigns have proliferated, with mixed results for companies as diverse as Apple, Clorox, Green Mountain Coffee, DuPont, Sotheby's, Gannett and GM. In some cases activists win board seats or special dividend payments or other corporate changes, whereas in other cases they win little and sell their shares quietly in the middle of the night. Such is the nature of animal spirits in public markets.

In one early activist campaign 20 years ago, I represented the United States Shoe Corporation, which had been a disappointing stock with three divisions – the crown jewel was optical category leader LensCrafters, the laggard was the core Shoe division, and the money loser was the women's apparel division in which some brands simply burned capital on leases that had too long to run. An activist named Greenway Partners (whose principal had been an Icahn partner) proposed breaking US Shoe into three separate public companies, which was at best a dubious and infeasible proposal that the shareholders roundly defeated. But the proposal itself helped put US Shoe in play – with management's hand strengthened since it had won its proxy fight. Within a year we were negotiating the sale of the Footwear division to Nine West, which had entered the fray with a public bear hug and closed its purchase with a price so high that Nine West would file for bankruptcy a year later, which suited us just fine.

Simultaneous with our footwear divestiture discussions came a hostile bid by European based Luxottica for the US Shoe parent, whose bid would go up dramatically partly in response to our Footwear divestiture price success. I doubt Greenway could have predicted these particular outcomes, but perhaps it had understood that a proxy contest, even if it failed, would put the company in play, and that in turn would drive value. All that came to pass, and a stock that had been trading at below $10 would soon be acquired at close to $30 a share.

Perhaps the most colorful recent example of activism was not in the corporate world but in the sovereign debt world. Sovereigns often default on their

[7] See Erin McCarthy, "Icahn Letter Pushes Apple to Buy Back More Shares," The Wall Street Journal, 9 Oct. 2014, <http://www.wsj.com/articles/icahn-pushes-apple-to-buy-back-more-stock-1412860351>.

own debt and expect renegotiation of terms. Few regions are as prolific at this game than Latin America, and within Latin America, Argentina has a particularly storied role in the annals of default. When activist hedge fund Elliott Management bought Argentinian debt, however, it noted that the indenture permitted a holdout to Just Say No, effectively blocking a consensual restructuring that would subordinate holdouts. Argentina was shocked: was the long proud tradition of sovereign default and renegotiation not so well established as to be essentially a right? US Federal courts sitting in New York found for Elliot.[8] The fallout PR campaign by Argentina cast the activists as greedy hedge funds, an ironic claim for a deadbeat borrower. Under its own indenture, Argentina was apparently on the wrong side of New York law, and those hedge funds were the champions of New York law. It may bear noting that Elliot's CEO, Paul Singer, is a New York lawyer.

The Argentine case is instructive precisely because it was successful. In the 1980s, too many activists lacked substance and were pursuing creating nuisance activity that companies would pay to end, often by repurchasing the activists' shares at a gain to the activitist. The practice, known as greenmail, would hardly make activists mainstream in corporate life. But in its more contemporary incarnation, activism grows because it is often (though not always) valid. A recent McKinsey study found that the median result of 400 activist campaigns led to excess returns persisting over 36 months.[9] Even if some activists' specific proposals remain misguided, the data suggests activists have been good at finding weakness and drawing attention to it. That by itself has value in rendering financial markets more efficient. Of course abuses persist too, but in general, activism has gone from often dodgy to often right. That trend matters.

What, then, can we say about activism from a deal maker's perspective?

- First, one size does not fit all; activists are neither all good nor all bad. Activists bring perspective to public light that companies and shareholders and other market participants then evaluate. Even when activist campaigns fail, they often sharpen market participant's understanding of corporate strengths, weaknesses, and possibilities. In corporate democracy as in political democracy, freedom of speech is a value even if some speech is offensive.

- Second, activism creates a robust dynamic between corporate fiduciaries and corporate shareholders. That is not by itself a bad thing, though it can

8. See "Argentina vs. Holdout Bondholders: The Epic Saga," The Wall Street Journal, 17 Jun. 2014, <http://blogs.wsj.com/moneybeat/2014/06/17/argentina-vs-holdout-bondholders-the-epic-saga/>; NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246 (2d Cir. 2012).

9. J. Cyriac, R. De Backer, J. Sanders, "Preparing for Bigger, Bolder Shareholder Activists," McKinsey & Company, March 2014.

be a distractive or even sometimes an obnoxious thing. Sometimes the shrillness is the activist's voice; sometimes it is the company's entrenchment; sometimes it is both.

- Third, as activists stimulate possibilities for change, deal makers may find increased latitude to drive change. Indeed, activists can be a deal makers' tool. In some situations in which we have represented a company wishing to buy a corporation, we find that activists can pry loose a business that officers and directors would have shielded from the deal maker's table. In other situations, activists can distract our client or create dynamics that we must educate our client's stakeholders to resist for good reason.

In some contexts successful activism may reduce deal activity. A successful activist campaign can cause a company to have a better board or management team, or to reorganize, or to use leverage more effectively, or to distribute cash it might otherwise horde or waste. These improvements may allow the company to remain independent rather than be taken over. An early leading academic proponent of financial buyouts of companies argued that many public companies in the 1980s were squandering public shareholder wealth and thus had become fodder for a takeout by LBO firms at some premium to public values.[10] But in the hands of a good activist, some wasteful public companies can be reformed as public rather than private companies.

In an earlier era in modern capitalism, a hostile bidder was called a predator because he was uninvited. That era has ended. Similarly, activists who stir corporate pots were once viewed as squawkers. But these birds of prey have demonstrated enough successful campaigns that they are often understood to be loud and smart – and in the final analysis financial markets are mostly concerned with money, not manners.

Corporate campaigns, like political ones, are not about activists versus directors, nor red versus blue states. They are about reason. Where companies have good reasons for resisting market sentiment, they should articulate those reasons. And where activists have a case, they can make it through the proxy machinery, the financial press, or wherever else they may speak. Democracy and capitalism are two sides of a coin: both bow to reason; both are a market for value.

Marshall Sonenshine
Chairman, Sonenshine Partners
Professor of Finance, Columbia University

[10] See Michael C. Jensen, "Eclipse of the Public Corporation," Harvard Business Review, 1989.

"All deals are hostile; it's just a question of the level of hostility." ~ Late partner of Senior Chairman H. Rodgin Cohen of New York law firm Sullivan & Cromwell

Part I: The Short History of Investor Activism in the United States

"IF YOU want a friend on Wall Street, get a dog," Carl Icahn once quipped. At the time his habit of buying shares in a company and picking a fight with management had got him ostracized as a corporate raider and "greenmailer". Oliver Stone borrowed the canine quip for Gordon Gekko, the cold-hearted protagonist of the film Wall Street'.

"Today, Mr. Icahn does not need the dog: his conduct is applauded by such pillars of the establishment as the head of the Securities and Exchange Commission, the main regulator of America's financial markets: Mary Jo White believes that shareholder activism has lost its distinctly negative connotation.
– The Economist, editorial, February, 2014

"Everything The Economist says about shareholder activism is wrong"
– Headline on a blog published by Stephen Bainbridge, William D. Warren, Distinguished Professor of Law at the UCLA School of Law in Los Angeles, February, 2014.

"All deals are hostile; it's just a question of the level of hostility." – Late partner of Senior Chairman H. Rodgin Cohen of New York law firm Sullivan & Cromwell.

The roots of investor activism in the United States trace to the years of the Great Depression. New laws and regulations were enacted (including the establishment of the Securities and Exchange Commission) with an aim at reforming business practices that were seen as contributing to the worst economic calamity of the 20th Century. The first activists were shareholders who thought the new rules were not enough. Their power and influence were limited. In the early days the principal method of expressing displeasure with corporate management was for shareholders to divest their shares – what was known as the "Wall Street Walk."

Following World War II, the primary activists were labor unions and social organizations. Using activism as a bargaining tool, the Association of Independent Telephone Unions (AITU) bought shares of American Telephone and Telegraph (AT&T) in 1949 to fight pension benefit cuts by the company's

management. In 1948, a member of the Congress for Racial Equality, James Peck, purchased one share of Greyhound stock to raise the issue of integrating bus seating in the South to the Greyhound management at their annual corporate meeting. That was seven years before the historic Rosa Parks bus boycott that ushered in the Civil Rights movement.

By and large, activism remained more of an oddity until the latter third of the 20th Century, when the technology-driven information age spawned new means of analysis, organization and communication. The successes of the Civil Rights movement and other activist social and political causes during the 1960s gave rise to beliefs that corporations could also be reformed in similar ways. In one case, a federal appeals court upheld the rights of shareholders – a group of medical students – to fight Dow Chemical's production of napalm, a widely reviled chemical weapon used during the Vietnam War. The illustrious Ralph Nader also engaged in proxy battles with General Motors during the early days of his consumer activism in the early 1970s. These cases generated considerable publicity – but not enough shareholder votes to carry the day.

By the 1980s, the rise of institutional investing forever turned the tide in the favor of investor activists. The late California State Treasurer Jesse Unruh was a pioneer, serving as a director of the largest pension fund in the country – the California Public Employees Retirement System (CalPERS). The fund was invested in Texaco, which paid a $137 million premium to avoid a takeover by the Bass Brothers (who owned a 9.9% stake). Unruh viewed this as "greenmail," a term that gained favor throughout a decade that also produced the term "corporate raider" to describe some activist investors, as well as "white knights" for investors who would rush in to rescue a company from a hostile takeover. Unruh pushed CalPERS to adopt a corporate governance policy in 1984. Thereafter, instead of passively holding its stock, CalPERS frequently held corporate managements to account through its sizeable shareholdings and outsized influence. Unruh also helped created of the Council of Institutional Investors (CII) to lobby for shareholders' rights – growing it from 20 public and private pension funds to more than 125 today with more than $3 trillion dollars in assets. CII's website boasts that many of its corporate governance policies "once considered radical" are commonly accepted standards today.

With the rise of institutional investors, the focus of activism shifted from social issues to corporate governance throughout the 1980s and into the

1990s. In fact, the U.S. Department of Labor encouraged this trend through its interpretation of the 1974 ERISA law, generally finding that pension plans administered by organized labor had a fiduciary duty to maximize shareholder value, and should use proxy fights when necessary to achieve that end. One of the chief proponents in the Labor Department in the mid-1990s was assistant Labor Secretary Robert A.G. Monks, who subsequently formed Institutional Shareholder Services (ISS), which has played a significant role in corporate governance issues for the past quarter century. By 1992, the rise in institutional investor activism prompted the SEC to revise its proxy rules to facilitate shareholder communication and lower the cost barriers to collective shareholder action.

The beginning of the new Millennium brought end the of the so-called "dot.com" bubble in the stock market and a mild recession, along with a spate of highly publicized scandals at big corporations like Enron, WorldCom, Global Crossing and Adelphia Communications. Management misbehavior at these and other companies – some resulting in criminal convictions and prison time – produced investor outrage, which prompted another surge in activism. In March 2004, The New York Times reported that the number of shareholder proposals related to corporate governance issues increased from just over 500 in 2001 to more than 900 in 2003. During the same period, a new crop of activists appeared on the scene – hedge funds. By 2005, they had grown to more than 8,000 funds with more than $1 trillion in assets under management. Unlike previous incarnations of institutional investors – mutual funds, pension funds, trust and endowments – hedge funds were difficult to define and notoriously secretive about their investment strategies, owing to minimal registration and disclosure requirements because of their partnership structures; most have fewer than 100 investors and most investors are qualified as "high net worth." Attempts by the SEC and federal lawmakers during the mid 2000s to require tighter regulation of the hedge fund industry generally failed. At the same time, many of the larger public and private pension funds and endowments began to invest in hedge funds because of their growing track record of market outperformance. As the hedge fund industry has continued to grow (pausing and resetting like other markets after the 2008 financial crisis), many hedge fund managers have engaged in investor activism in order to bolster their returns, leading us to today's frenzy of activity.[11]

11. Source note: much of this short history is derived from a course description in Investor Activism at Harvard University, Professors Lucian Bebchuk and Beth Young, Fall 2009.

"I think the short answer to why activism is on the rise is - it's money" ~ Edward Horton

PART II: Activism Works – Here's Why

"It was not a long ago that the 'activist' moniker had a distinctly negative connotation. It was a term equated with the generally frowned-upon practice of taking an ownership position to influence a company for short-term gain. But that view of shareholder activists, which has its roots in the raiders of the 1980s takeover battles, is not necessarily the current view and it is certainly not the only view."

– SEC Chairman Mary Jo White, remarks at the 10th Annual Transatlantic Corporate Governance Dialogue in Washington D.C. in December 2013.

Those 1980s takeover battles generated outsized headlines and one outsized movie (Wall Street). And to a certain extent they still generate headlines a quarter of a century later, including some of the original characters like Carl Icahn, and newer incarnations like Bill Ackman of Pershing Square Capital Management. But the reality, participants in this special report for The M&A Advisor say, is hardly as sensational as the headlines may indicate.

"Activism is such a broad term," says Edward Horton, Partner at New York law firm Seward & Kissel LLP. "People come to us with this view that activism implies a hostile approach that always ends up going through a very long and expensive proxy battle that's played out on the front pages of the Wall Street Journal. They're looking at people like Ackman and the household names. In my practice, the majority of what we consider to be activist work or activist advice is nothing like that. It's advising people on such mundane things as Section 13 filings, reviewing corporate structures… or more specifically writing letters and advising on the level of discussion they have with companies."

Horton's firm works with clients that are activist funds as well as issuers but the majority of his work, he says, is in fund advisory, which he has been doing for about 10 years. And, yes, the work is increasing.

As to why activism is on the rise, "I think the short answer to that is – it's money," Horton says. "The money's flowing into activist funds and it's significantly greater than it was even three or four years ago. And the institutional investors that are

coming into these funds are also of character that I don't think you would have seen even four years ago. I'm talking about pension money coming in here; some of these foreign sovereign funds coming in. So – large amounts of money that previously didn't want to get involved in the activist world are now coming in, in a big way." New money is increasingly coming in because "activism does work – it does work for current investors," Horton adds.

At the New York law firm Sullivan & Cromwell (which dates to the 1870s), most of the work of Senior Chairman H. Rodgin Cohen goes into defending companies from activist incursions. But Cohen agrees that activism does work – at least for the activists. "There have been activists who have been quite successful. In what has become known, depending on your point of view – either the wolf pack or hyena phenomenon – activists can be successful with relatively small stakes. They have huge amounts of money now. There are all sorts of estimates, but activist funds, many people say, are $150 billion or more. They now receive more support from institutional investors – and that's a pretty powerful combination. And the reason the funds have grown so much is – to their credit – their returns, at least for the short term, have exceeded other hedge fund operators and other money managers. So that attracts even more.

"The other side is – over the past 5 to 10 years – so many of the defenses which companies have had in the past have been stripped away in the context of corporate governance demands. Nobody today has an active rights plan… you no longer have classified boards… you often have special shareholder meeting rights… so the defenses against activists are less, their capacity is more and that's what leads to the overall success and rise of the activists."

Cohen also wonders if the U.S. market conditions since 2009 – a spectacular rise in the equities market against the backdrop of virtually zero interest rates – has contributed to the current frenzy in activism. "If you're simply in U.S. equities, as most of the activists are, you can expect to do a good job or you should be really in trouble if you didn't. The bottom line – some of them have done very well… but I think you have to look at in a broader sense and say 'If I were going to just invest in U.S. equities, how that would work out?'"

You may not find a more constructive observer of investor activism than Gregg Feinstein, Managing Director and Head of M&A at New York investment bank Houlihan Lokey, which, interestingly, focuses equally on

"Over the last several years you've seen a great deal of success by activists in their investment returns," ~ David E. Rosewater

advising issuers and activists. "The stats show that the returns for activist funds have been in the top 25 percent of hedge funds for many years. So it's clearly financially true that activism works," Feinstein says. "And if you look at the assets in hedge funds… it's also obviously working." Feinstein has been in the M&A business for more than three decades; at Houlihan for the past 10 years, and leads its shareholder activism practice. "Houlihan has become a leader in activism on both the defense side and on the activist side," and today's activism is a "new and improved form," he says, adding that since the recent financial crisis, activism has "come back generally in a more academic, elegant and a more powerful way." Feinstein describes the new breed of activists as more analytical and intellectual – many are very quantitative with very specific plans involving spinoffs, split-ups, share repurchases and capital structure. "Many have common themes which result primarily from many years of artificially low interest rates," he says. "So anything that one can turn into a 'bond' or anything that you could borrow for, algebraically, was going to enhance the stock price. So if Apple is able to borrow at a one percent and use that money to repurchase shares, it's going to help the short-term value. If one can trade something that acts like a bond, one can increase value since investors are so yield-hungry now. The government has helped capital to be so cheap that it leads to all these opportunities. We are also again seeing campaigns to sell the company because you have a very strong M&A market."

David E. Rosewater, Partner in the New York law firm Schulte Roth & Zabel LLP, has been tracking activist trends through a series of surveys that his firm has conducted with the data provider Merger Markets. "Over the last several years you've seen a great deal of success by activists in their investment returns," Rosewater says. "It's been a very successful strategy and that of course attracts people to the strategy. It also generates alpha and that's what investors are always looking for – the ability to generate returns uncorrelated to the market. That has attracted additional capital as well. From there it's a bit like a snowball down a mountain. Success breeds more interest and more interest breeds more opportunities for success."

DEAL NOTES

ACTIVISM IS HERE TO STAY: Schulte/Mergermarket Survey

Schulte Roth & Zabel LLP published its fourth edition of Shareholder Activism Insight, a survey conducted in association with Mergermarket, in late 2014. Shareholder activism, clearly, is here to stay, the report concluded. It examines the opinions of activist shareholders and corporate executives broken out into two groups, one based in the U.S. and one based in Europe, in an effort to gain insight into the drivers behind activism in each of these markets over the next 12 to 24 months and the underlying sentiment of market participants.

"The dynamics between activists on the one hand and corporate boards and management on the other are, as always, the driver of the level of discourse about company strategy," the report states. "They are also a determining factor in whether situations play out cooperatively behind the scenes or in contentious, public spectacles. The current backdrop is one of continued growth of activism and the burgeoning power of stockholders. Research group HFR, Inc., recently found that four prominent activist funds had grown their funds under management by $9.4 billion in the first half of 2014 to $111 billion gaining more in that period than the previous two years combined. This signal of the expansion of activist coffers is one that companies cannot afford to ignore."

The results of the 2014 survey reflect the continuing rise in the volume of activist campaigns:

- Some 98% of respondents expect an increase, with more than half of those expecting the increase to be substantial.
- Upcoming activity is expected to be driven by hedge funds (60%) and union funds (24%), which is broadly in line with results of the previous survey conducted in 2012.
- The drivers behind the increase in activism are numerous and varied:
    - o 37% of US respondents are most likely to cite poor management performance as their primary motivation for seeking changes to corporate boards.

- o 36% cite a desire to improve corporate governance.

- A substantial number see more harm than good coming out of hostile, high-profile activist campaigns. Instead, respondents are more likely to recommend an active dialogue with management (38%) or shareholder resolutions (32%) as the most effective activist strategy.

- European respondents are divided on the number of shareholder proposals that will receive majority support:

  - o About one-third of respondents say that fewer than 10% of proposals will be successful this year.

  - o Only 12% are optimistic that 30% or more shareholder proposals will be met with majority support. Remaining respondents have more moderate expectations of proposal acceptance rates.

  - o European and U.S. respondents are in agreement that communication is key to achieving desired results. Eighty percent of European respondents cite dialogue/negotiations with management/board as the most effective strategy for achieving desired results, while the remaining 20% say the same of shareholder resolutions.

A complete copy of the report can be found online (at this link: http://www.srz.com/files/upload/Publications/SRZ%202014_Shareholder_Activism_Insight_Report_HR.pdf)

PART III: Does Activism Have A Downside?

"The goal of an activist is to create as much disruption as possible at their target company in order to accomplish their financial objectives – at any cost."
– Matthew Sherman, President, Joele Frank

At the beginning of this report we noted the ringing endorsement of investor activism by The Economist in 2014, as well as the claim that "Everything The Economist says about shareholder activism is wrong" by Stephen Bainbridge, William D. Warren Distinguished Professor of Law at the UCLA School of Law in Los Angeles. The Economist editorial cited an analysis of around 2,000 interventions in U.S. companies from 1994-2007 that found not only that

the share prices and operating performance of the firms involved improved over the five years after the intervention, but also that the improvement was greatest towards the end of the five-year period. Bainbridge pointed out that the analysis "was done by folks with skin in the game – a deep ideological commitment to shareholder activism, so deep that they set up a Harvard law school clinic to promote it. I'm not saying they skewed their numbers. They are too good scholars to do that. I am just saying that all empirical studies need to be taken with a grain of salt and those by folks with an agenda need a larger than usual grain. (And, yes, I have skin in this game too.)"

The negative effects generally cited against activism boil down to: 1) will the long-term effects on companies outweigh the short-term value gains to shareholders (on which the jury is still out) and 2) the disruption that activism can cause internally, affecting management, employees, industries, customer and communities.

Matthew Sherman is President of Joele Frank, a New York financial public relations and investor relations firm with a large practice in M&A and defending corporations against investor activism. He, like others, sees a myriad of reasons for the rise in investor activism in recent years – including the influence of proxy advisory firms like ISS and Glass Lewis. Sherman also sees an outsized role the media is playing in the trend. "I think the media has played a large role here. Much of the mainstream financial media now has a dedicated activist beat that reports on daily news and developments of the activist investors. And the media now lionizes activist investors, presenting them as agents of change and corporate governance transformers rather than corporate raiders – this is the most telling sign of how far the public perception about activist investing has shifted."

David Rosewater, whose law firm represents both activists and companies but is most frequently found representing activists, acknowledges the other side of the argument. "I think clearly there's plenty of opinion that shareholder activism can be harmful, depending on the circumstances. As with everything, it's really specific to the situation. There can of course be circumstances involving particular situations where activism could end up with unexpected results. However, most activists, and certainly all the reputable activists, are working with the focus on benefiting shareholders in general and their track record is quite good overall. That's what the board members are supposed to be doing anyway."

"Activist investing is nothing more than hostile M&A on the cheap," ~ Matthew Sherman

Cohen, whose work is on the defensive side, says: "It's relatively early, I think, to be able to make a definitive judgment on this new wave of activism." As to possible negative effects of activism, he points to a case where an activist forces the sale of a company at a 20 percent premium. "Over one year that's a hell of a good return. The question is, if the company had stayed around for five years and been sold or been around for five years and been independent, would it have returned more to the shareholders over that period of time?" Cohen agrees corporations exist primarily for shareholders, but "they do have other constituencies. How much is there a transfer of short-term wealth to investors at the expense of the employees and the communities that are served? People can speculate about it but I haven't seen the studies that demonstrate one way or another."

Adds Cohen: "One of my former partners who unfortunately passed away a few years ago once said 'All deals are hostile – it's just a question of the level of hostility.'"

Sherman points out that today's form of activism has a much lower barrier to entry. "Activist investing is nothing more than hostile M&A on the cheap," he says. "When you think about it, an activist investor can stand on a very large soap box and gain a lot of traction owning only one or two percent of a company." Sherman also cites possible long-term effects as well as effects on employees, customers, and communities as cause for concern. "Activism can have a significant disruptive impact on a company's operations, and in particular, on its employees, customers, and business partners. Employees may become fearful that their jobs are at stake and customers may become concerned that the company may not be able to continue delivering its products. The goal of an activist is to create as much disruption as possible at their target company in order to accomplish their financial objectives – at any cost."

When asked about the negatives of activism, Gregg Feinstein said: "All you have to do is read articles authored by Wachtell Lipton (a New York law firm), who is focusing the market on some of the negatives. I think the argument

is really one of short-term versus long-term and whether overall it's helpful. I think it clearly causes managements to evaluate what they might not evaluate on their own or at the same speed and degree."

PART IV: Is Activism Here to Stay?

Part A: What about Europe?

"The consensus view is there's a fair amount of undermanaged companies in Europe and ultimately you will see this grow." – David Rosewater, Partner, Schulte Roth & Zabel

Investor activism may be raging, rising tide in the U.S., but across the Atlantic it's barely a ripple by comparison. At the M&A Advisor's International Financial Forum at Bloomberg's London headquarters October 22, 2014, Aaron Kirchfeld, European M&A reporter at Bloomberg News, chaired a panel discussion entitled "Activists in the Shadows." The key question posed to the assembled panel of shareholder activism experts was whether the United Kingdom and Europe were about to experience aggressive U.S.-style shareholder activism. The panelists agreed that there are cultural differences that may inhibit some the practices pursued by activist funds in the U.S. But there are other aspects of shareholder and corporate behavior and corporate governance structures in the U.K. and Europe that suggest that this region is ideally suited for activist funds to play a more active role in seeking to improve shareholder benefits.

The participants in this special report generally agreed with the London panel. They cite cultural differences as well as a plethora of regulatory structures, differing from country to country across the continent, as inhibitors to U.S.-style activism invading Europe in a big way. "It may change a bit because of the success of activism here," says Sullivan & Cromwell's Cohen. "But in a number of countries there are a limited number of targets, or they are protected by the government or they are in private hands. For example, in Germany there are a large number of substantial companies that are private and activism is futile at these companies… I think because of the differences in culture, government and owner structures as such I would be surprised if activism would ever be as high in Europe as in the U.S."

David Rosewater notes that Shulte Roth & Zabel opened an activism practice in London last year. But he, too, does not see a sudden surge in activism coming to Europe in the near term. "To some extent it's cultural. The markets are smaller. They're generally thought of as more collegial rather than the rough-and-tumble

"It seems that any attention is good attention for an activist."
~ Matthew Sherman

U.S. market view. With the proliferation of activism, it's not surprising that people who view this as a strategy would look around for other low hanging fruit. And the consensus view is there's a fair amount of undermanaged companies in Europe and ultimately you will see this grow. It's certainly there but it will be a slow build."

Adds Houlihan Lokey's Feinstein: "Everyone has expected a migration to Europe. It has not happened in any material way yet. I think it will happen slowly. We've spent some time – we're working on Intercontinental Hotels now, in London – an $11 billion company. Each country has its own rules. They're not all the same. You have to speak the language. And foreign companies don't necessarily appreciate 'people coming over from the U.S.' You really have to be a lot more elegant, certainly a lot more patient, in Europe. In England for example, you need to be patient, respectful and genteel, and you need to go to the shareholders first."

Part B: The absence of private equity firms

"That's not what private equity is looking for – it's a different philosophy of investment." – H Rodgin Cohen, Senior Chairman, Sullivan & Cromwell

Is there a role for private equity firms, who have largely been absent in the latest rise of activism? Participants in this report say not generally because the business model of private is significantly different – PE firm managers generally aim to acquire and firm and operate it with their own team for 5-7 years before selling or going public whereas activists aim to change strategy within a given company in order to enhance value for current shareholders. Says H. Rodgin Cohen: "That's in large part a difference between a short term and longer-term investment horizon. That is not consistent with the activist approach and it's pejorative, but I think not totally off the mark, to talk about instant gratification for the activist. That's not what private equity is looking for – it's a different philosophy of investment."

Adds Feinstein: "If what they want to do is acquire a company, the worst thing they (PE firms) can do is be the activist who catalyzes a sale, because they're

going to sell to anyone other than the PE firm because they were the one that 'put them into play.'"

Part C: Winners and losers in M&A?

"As a banker, the peculiar thing about activist defense is that you generally make more money if you lose than if you win." – Gregg Feinstein, Managing Director & Head of M&A Group, Houlihan Lokey

Within the M&A industry, who benefits and who loses from the current wave of activism? Participants in this report agreed that service providers, particularly data companies, law firms, proxy service firms and public relations firms benefit from the increase in activism. The big winners? "It's almost a win-win for activists in any scenario," says Matthew Sherman of Joele Frank. "If the activist runs a successful campaign, they've achieved their objectives. If they settle, they can claim credibility. And if they lose, they still attract outsized attention from the media and other investors. In short, it seems that any attention is good attention for an activist." And the losers? Says H. Rodgin Cohen: "I think the negative impact is definitely on the companies that have to go through it – it's an incredible diversion of management time, resources, funds, and so I see a lot of clients who have to spend a lot of money for what ultimately is not a useful purpose. Quite clearly, if you go through a proxy fight, that money that is spent goes to service providers. Personally I would prefer our clients not have to go through this."

Feinstein points out that in some cases, the apparent losers are the biggest winners. "Everyone involved in M&A is helped because of activism. It's been enormously stimulative to M&A. It helps some clearly more than others – Goldman Sachs, who has the most active defense practice, probably benefits the most. The activist side is still in its infancy. As an example, in our activist campaigns that have been publicly disclosed, the investment banks who seemingly lost made about five times what we did. So, as a banker, the peculiar thing about activist defense is that you generally make more money if you lose than if you win. A lot of activist defense assignments are not set up with a commonality of interests because often the investment banker is paid more if the transaction that the activist is suggesting happens than if they can explain why it is not a good transaction."

As a data provider, S&P Capital IQ has created its own team to serve activist investor clients. Pavle Sabic, Director Credit Market Development there

describes the services he provides as crucial to analysis by activists in a variety of ways. "Hedge funds look at 13D and F filings. Investment banks use our data, drilling down into the earnings and financials, and from there they have a look at similar companies. There are many different ways you can use data to find opportunities for investor activism."

DEAL NOTES

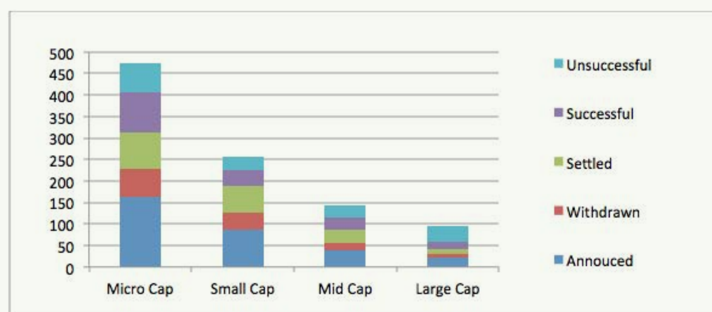
COUNTERINTUITIVE TO THE HEADLINES: Small companies are the biggest targets

S&P Capital IQ publishes insightful blogs by its researchers and analyst on a regular basis on the "Insights" page of its website (link: http://www.spcapitaliq.com/our-thinking/insights.html). In January 2015, Pavle Sabic, Director Credit Market Development, offered some interesting – and counterintuitive – perspectives on where most of today's investor activism occurs – in micro and small cap companies.

"In recent years, investor activism has captured media attention and it is clear to see the effect it is having on the markets," Sabic wrote. "For example, Pershing Square Capital Management's activist campaign for Allergan saw Allergan's stock price rise 87.5% from announcement to exit. But that kind of campaign is not always the norm."

Using S&P Capital Investor's activism database, Sabic shined light on two popular misconceptions: 1) big companies are the exclusive targets of activists, and 2) activist campaigns always involve a hostile takeover threat.

In fact the data showed that over the past three years, micro-cap companies have been involved in 474 activist campaigns. By comparison, Large Caps have seen only 20% of that – 96 campaigns.



Sure, you may say, that makes sense because there are far more micro-cap companies than large cap ones. But Sabic drilled deeper into the data and found that microcap companies are far more likely to be involved in a "successful" activist outcome than are large cap companies.

Last 3 Years	# Of Successful Campaigns	# Of Unsuccessful Campaigns	Ratio Between Successful To Unsuccessful
Micro Cap	91	69	**1.32**
Small Cap	35	32	**1.09**
Mid Cap	28	29	**0.96**
Large Cap	16	37	**0.43**

One more note of interest: in its database, S&P Capital IQ identifies activist campaigns under 9 categories, ranging from "takeover bid" to "non-confrontational communication and engagement." Want to guess which gets better results? Read Pavle Sabic's conclusion in his blog (link: http://www.spcapitaliq.com/insights/investor-activism-popular-misconceptions).

Part D: Here to stay but in what form?

"Overall there probably will be waves of this going forward." – Edward Horton, Partner, Seward & Kissel

Is investor activism here to stay? Participants in this report believe some form of activism will always be around but differ on the timing and extent of the activity. Says Matthew Sherman: "The amount of funds flowing into it speaks for itself and activism today is an accepted form of investment. This has led to a new paradigm in Board and management engagement with investors in general. Despite the public perception, many companies and their Boards are doing a lot of the right things, notably, maintaining an open and active dialogue with the investment community."

"The only thing that has caused any significant ripple in activism in the last 10 to 15 years was the financial crisis, which affected everybody," says David Rosewater. "Clearly activist funds were not immune, but not because of the activism component. Value investing has been here forever and activism is

"The only thing that has caused any significant ripple in activism in the last 10 to 15 years was the financial crisis, which affected everybody," ~ David Rosewater

really value investing with the activist acting as the catalyst, instead of waiting for the catalyst to occur. Why that should somehow be short-lived is not clear to me."

Supply and demand may be a factor in the level of activism, says Edward Horton: "There are only a certain number of attractive targets, and I don't think it's exhausted, but not every company and not every industry is as attractive to activist holders as others. Overall there probably will be waves of this going forward."

And Rodgin Cohen says the markets will be the ultimate judge of the success of today's activist wave. "I think it's here to stay – as long as we have good markets," he says. "How much of the success is due to the policies and pursuits of the activists, and how much is due to an extraordinary bull market. And when the market goes sideways or the wrong way, that's when we'll know. If the activists can continue to prosper through that, it's probably here to stay and if they can't, the real results of it will be demonstrated."

PART V: An Activist Team Has Its Say

Meet David Nierenberg and Christopher P. Davis

Most activist investors are unwilling or reluctant to discuss the nature of their work publicly. As noted in the short history of activism, hedge funds have fewer disclosure requirements than do other many other investment vehicles. Thus we are grateful to have had the opportunity and privilege to interview David Nierenberg, Founder and President, Nierenberg Investment Management Company, Inc., Camas, WA, and his trusted counsel, Christopher P. Davis, Partner, Kleinberg Kaplan law firm, New York.

Nierenberg has been involved in activist investing in two different ways over 30 years. In 1985, he left a partnership at Bain Consulting to go into the venture capital business at Trinity Ventures, where he invested in financial services, healthcare and turnarounds. His experience at Trinity included

serving on boards of directors of companies the venture firm was invested in. In 1996, he founded Nierenberg Investment Management Company, which manages the D3 Family Funds. D3 Funds investors are "sophisticated" investors that have been in the fund "for decades" but by-and-large are not institutional investors. The size of the fund is undisclosed. Over nearly two decades, Nierenberg says, D3 has been taken an activist role in about 20 companies that it has invested in.

Davis has two decades of legal experience working with activist investors including the much publicized Elliott Associates L.P. "We do not do defense work," Davis says. "We are [a] full service counsel to hedge funds. We only represent the activist side of the equation. The fact that we don't represent corporate America has served us well. We don't have the conflicts that some firms who try to walk both sides of the aisle do."

This brings us to how Chris Davis and David Nierenberg found each other. "We used to be a client for many years of a much larger national firm and at one point they decided their job was the defense of corporate America," Nierenberg says. "And even though we believe we approach activism in a constructive and diplomatic way, that law firm fired us because we did not jibe with their mission. So we set out looking for someone who did what Chris did, and as we did our reference checking we were delighted to learn that he had the kind of constructive engagement approach that we think is right for our personality and our style, and we've been working with him ever since."

Nierenberg was asked to explain his philosophy toward activism. His response:

"If you think generically, what are the most important roles of the board of a company, I might say three things:

1. To work with management to set strategy and resource allocation program with management;

2. To pick the right Chief Executive Officer to execute that strategy and to oversee the CEO's performance;

3. To set the tone at the top – including having rational, appropriate and fair relationships between performance and rewards.

Whenever we have been roused to become active in a company it's because we saw something that did not seem right to us involving at least one of those three objectives.

"There's always the tendency to think of the most recent, high-profile deal and say 'Ah, ha! That's activism!' The reality is that activism has an immense array of permutations."
~ Christopher P. Davis

This is a small firm and I'm the principal person here that's involved in activism so there's a serious time constraint on the number of campaigns which I can simultaneously pursue. It takes a while," Nierenberg states.

He further explains that some activists "send out a nasty press release and bash people and play a smash-mouth game – which I've only done once and decided that was definitely not the way I wanted to play the game." Instead, Nierenberg does his homework and meets quietly with management and boards and pursues rational discussion and negotiation. "It is much more time-consuming endeavor because it requires you to establish relations of trust with people with whom you have disagreements about business judgment, and sometimes – rarely, fortunately – but sometimes, disagreements about whether they have conducted themselves properly."

Adds Davis: "There's always the tendency to think of the most recent, high-profile deal and say 'Ah, ha! That's activism!' The reality is that activism has an immense array of permutations. On the one hand you'll wind up with the nasty proxy fights, litigation, tender offer types of high profile things. On other hand, I think an immense amount of activism, as David says, has been done on a tremendously constructive basis. Activism is at heart value investing. It's finding an undervalued target and trying to find a way to unlock that value. So maybe it is a little more public, unlike how a mutual fund might have approached it behind the scenes, but the goal is still the same thing – make the best company possible, get the stock price up and have the shareholders benefit."

A grain of sand that stimulated an oyster to make a pearl

Nierenberg states: "So why is it that boards don't always do those things? Several reasons – the first is oftentimes boards become too clubby, too familiar. You can imagine that any group people who have worked together, often for a long time – even decades – can become comfortable that way. The problem of that comfort is it can stifle questioning, dissent and disagreement. I like to think of the maybe hackneyed analogy – a grain of sand that stimulated

an oyster to make a pearl. If no one is in the boardroom asking the kind of question that makes people uncomfortable, then I wonder if that board is actually doing its job. Too often in past, one of criteria for the selection of board members is what I call 'clubbability.' Is this a person that we happen to know socially? Can we get along with this person? So that's one problem – it's really a human nature problem – most people don't like to stand up and dissent.

"The second thing I've observed over the years is that the composition of boards too often reflects where a company has come from, rather than where they're going to. In other words, it may reflect industries, capabilities, geographies, that had a glorious past but may not be relevant to the future. But there seems to be a presumption that once a person is put onto a board, that person will continue serving until they either die, or are disabled or hit a mandatory retirement age, rather than thinking about what skill sets and capabilities does this company need on a going forward basis to be successful, and how does the current composition of the board compare with those requirements and what changes might be appropriate to help the company on its way."

"I'm trying to limit myself to the most common problems rather than the most egregious examples of immoral behavior like back-dating of stock options. I'm trying to be – as I think I am most of the time – empathetic about how it is boards get into this kind of rut. And if they are in that rut, then what are they doing? They may not be making the right decisions about what the strategy of the company should be. They may not be allocating scarce resources of capital and management talent towards driving the growth and value of the enterprise for all stakeholders, and they may not be making tough decisions that need to be made about who should be running the company against what objectives and how they should be rewarded.

"Let's face it – what resources does a company have? It has its balance sheet, and it has its off-balance sheet assets which are sometimes process know-how, but most important usually are its people. And if it doesn't allocate them appropriately, it can stagnate or worse."

A board indicts itself in a high profile case

Says Davis: "David makes a really good point about the clubbiness of boards, and there's an immensely interesting example that came out just in this last

"Let's face it – what resources does a company have? It has its balance sheet, and it has its off-balance sheet assets which are sometimes process know-how, but most important usually are its people. And if it doesn't allocate them appropriately, it can stagnate or worse." ~ David Nierenberg

year [Sothebys]… That's exactly what activists worry about. There's this clubby nature that interferes with accountability and that's what the problem is really, I think. And it's pushing the activist movement.

> Wall Street Journal, April 29, 2014: WILMINGTON, Del. — A court hearing Tuesday on a corporate takeover-defense mechanism used by Sotheby's has shined a bright light on discord inside the auction house's boardroom.
>
> The hearing, devoted to the company's use of a so-called poison pill to keep activist investor Daniel Loeb from buying more Sotheby's stock, turned into a public airing of the board's concerns about the company's performance just one week ahead of a shareholder vote to replace three directors.
>
> Lawyers for Mr. Loeb's Third Point LLC read aloud from emails among directors, who privately voiced some of the same concerns he has been raising since October: Sotheby's was overspending, paying its executives too much and falling behind its rival Christie's International PLC.
>
> "The board is too comfortable, too chummy and not doing its job," director Steven Dodge wrote in one email. "We have handed Loeb a killer set of issues on a platter."

"The average hedge fund manager is a fiduciary and has to produce on a consistent basis or money walks out the door," says Davis. "They're living in a world where accountability is front and center every day, and they look at boards where it's not and they say 'Hold on. You've got our money and you're not doing a good enough job with it.' They're not looking to throw people out for the sake of throwing them out. It's expensive and time-consuming and they've got better things to do. They're looking to make changes so they can get that value returned to shareholders."

Adds Nierenberg: "We focus only on microcap companies, the smallest public companies. The most common issue that I've been working on lately, across multiple companies, is the company that has had a growth vehicle in the past which served it well but which stopped growing for any number of possible reasons. It may have saturated the market. It may have been eclipsed by another technology. It may have been leapfrogged by a competitor. For whatever reason, the glorious engine of the past has started to sputter. And the company may have an installed base, recurring profitable revenue from that business, it may have a strong balance sheet. And so often what seems to happen is that the management and the board treat the financial assets of the company as if their principal purpose is to do everything they can to make the company once again into a growing enterprise.

"The market does like to reward growth more than it likes to reward stagnation, and these people have often grown up in a rapid-growth environment. So they may feel so compelled to find ways to restore the growth that they may simultaneously commence too many growth initiatives without first discerning which of them may be the very, very best, and then metering out the resources for that new growth initiative in a careful, oversight way that a good venture capitalist would do. And they wind up dissipating the financial strength of a company and what's of concern to a value investor like me is that they are using up the margin of safety. And they often wind up making the companies too complex. They wind up with too many simultaneous initiatives; too many to oversee well. And as a result the stagnation may continue or may deepen into a decline," Nierenberg says.

"Companies should not assume that continued independent existence while stagnating is their natural right." –David Nierenberg.

He adds: "The insiders really need to pull back and do two things. The first is to determine what the very best growth opportunities are, if any exist. And second, they need to think about alternative ways that they might reward shareholders if they cannot resume the growth. For example, think of any kind of national restaurant chain or retail chain that you patronize as a consumer, particularly one that's been growing 20 to 30 percent a year for a long period of time. At some point it will reach saturation, and what will it do then. Well, some companies – those that have a profitable ongoing model – will at that point start to think about using cash to reward shareholders with dividends, or share repurchases to continue providing an attractive total return to the shareholders

"Companies should not assume that continued independent existence while stagnating is their natural right."
~ David Nierenberg.

through all possible means. Or they may even sell themselves. But companies should not assume that continued independent existence while stagnating is their natural right.

"It may well be that there are other outcomes, other strategies, other ways of rewarding shareholders which ought to be considered, even if that may mean that the company may not continue in its core business, the company may not in its independent existence, and – God forbid – some members of the board of directors might lose their prestigious jobs. At the end of the day, what the companies should be trying to do is do right by their stakeholders rather than being a self-perpetuating vehicle for the benefit of the insiders at the expense of everyone else."

Is this process like the Five Stages of Grief?

Nierenberg chuckles, saying: "There is something to that. When a business has been good to you for a long time and it stops growing, it doesn't mean that it's a bad business at all. It means that the company should be repositioning for the benefit of stakeholders, rather than say pouring money futilely into growth. And in fairness to the insiders, it is not an easy decision to make. Because if there are ways to make the growth persist in contiguous spaces or other geographies or market segments that the company hasn't penetrated yet, then that's a good thing. The last thing you want to do is walk away from what has been a great cash cow. But it takes good business judgment to decide when enough is enough."

Adds Davis: "You always hear the activists being criticized for following short-term interests – I think that's way, way overblown to the point of being silly – but boards almost never own up to the fact that for many of them, those board positions are incredibly and personally important to them from an economic view. And although they like to pretend that they don't have conflicts, for many of them they do have a conflict, just like when you're dealing in a small or microcap company – or even in some medium-cap companies – the reality is the executives of that company who are desperately holding on – that is

likely the very best job they are ever going to have. So being swept out, either in a public fight or a deal where there's a chance of control oftentimes means at least a serious setback, if not a downward trajectory in their career."

Says Nierenberg: "And it can be economic, but it can also be status. It also can be the sense of power and influence that one might attach to being a corporate director. It can be a combination of economic and psychological reasons. But, again, at the end of the day it's not an entitlement. You're there to help the company and help the shareholders."

How this activist gets results

"I would say, in the words of Justice Brandeis – 'sunlight is the best disinfectant,' by which I mean – data is a good thing," Nierenberg says. "It's good to look at historical data of the performance of a company or a business on its own and relatively to a properly constructed peer group, and to look back over the period of time and then answer the question, 'Has this been adding value?' There's a lot of rhetoric that comes from activists, particularly of the smash-mouth variety. I find it much more useful to revert to those three statements of the purpose of the board, and ask people relative to those benchmarks – 'How have we done?' and to look at that through the prism of history and see how the company has done and let the facts speak for themselves. If you do that – look at a relevant peer group – you can often find companies that have pursued other strategies which have produced different results. But generally I find that people do respond to data.

"And I would say that insiders do in one other way as well – they can count. And if they see that there's a certain percentage of the shares of the company that are in the hands of others who are asking the same kinds of questions that I might be, at some point almost anybody can read the handwriting on the wall. So without making yourself into a group, in the legal sense, if enough people are in touch with the insiders asking similar questions, the stubbornness or defensiveness that sometimes exists can be overcome.

"So if I'm looking at a company where I'm thinking about becoming active, one of the first things I'll do is look at the pattern of ownership, to see whether or not the pattern is more or less likely to permit success. As a small practitioner, I have to think about a very important thing to measure which is called 'return on time.'"

"When a board sees an activist in its stock, one of the first things it will, not surprisingly, do is try to take temperature of its other large shareholders." ~ Christopher P. Davis

Adds Davis: "When a board sees an activist in its stock, one of the first things it will, not surprisingly, do is try to take temperature of its other large shareholders. Nowadays, as say opposed to, say, the 1970s, the institutional ownership is huge as a percentage. So when they go out and start to take the temperature of those other shareholders, or, increasingly, as those other shareholders – even if it's not happening publicly – are starting to reach out to the company to let them know how they view it, that becomes the real important influence as to how the company responds. Even the worst boards can count, and if you're at 60 to 90 percent institutional ownership, and those people for good economic and investment reasons have very similar viewpoints, why are you fighting? Therefore one of the things that other shareholders who aren't activists themselves can do is, if they agree with the thesis, pick up the phone and say so. Sometimes you'll hear allegations of group activity that's not being disclosed. That's incredibly nonsensical – you've just got people who have come to the exact same investment thesis. When people act together, and it happens sometimes, they disclose it and they move on. But you've got a situation in most companies where not surprisingly people can see the writing on the wall. And it's a question of conveying that to the company and the board."

How to you respond to critics who cite potential negative effects of activism on long-term performance and on employees and their communities?

Says Davis: "I'm a Delaware law aficionado, so I think the question of other constituencies doesn't come into play. The question is one of the shareholders. And shareholders on the whole are not bothered by activism. The fact that so much money is moving into the space, there are such great returns, is a function of the fact that activism has worked. I agree there's still work to be done but some of the studies that have been done are fairly positive in indicating even three and five years out that companies who have simply gotten on the radar because activists have approached are by-and-large outperforming their peers who didn't have that pressure and that spotlight. Are their failures? Absolutely. No system is 100 percent. It would be very hard to say Bill Ackman's foray

into JC Penney was a success. It wasn't. But for every J.C. Penney there are a number of Canadian Pacific's and those turned out quite well."

Nierenberg adds: "You can find legitimate criticisms that can be leveled at activists for both reasons. Again, human nature is in play here. There are as many types of interactive styles as there are personalities. And, yes there are some people in the activist community who act in different ways. I would also note that there board directors, board chairmen and CEOs who handle themselves in different ways. That's the way the world is. And sometimes your behavior as an activist results from what the incumbents have done. In other words, if a management team outright lies to me about something, or does something illegal or immoral – and unfortunately I have to say in 30 years of being on boards I've seen a few of those episodes – then I'm going to act in a much tougher way, in a much more impatient way, than I might behave if I'm dealing with competent, ethical and well-behaving people.

"There is a spectrum of near-term to long-term points of view among activists. Sometimes there can be almost a knee-jerk request when looking at a cash-rich company that it should purchase stock or it should pay a special dividend, and again what's right depends on your best application of business judgment under the circumstances. There is no one-size-fits-all. As I often say to people when they ask me why I'm not asking a company to repurchase stock, for example, the kind of company that should repurchase stock should be a company that not only has the cash to do it, but it should also have a highly profitable business model that the shareholders should want to own a larger percentage of. And the shareholder, through the company's repurchase, should be buying those shares back at a price that is considerably below the intrinsic value. And if those criteria of profitability and value are not met, then a rote response to repurchase shares doesn't make sense. So I think some of those criticisms that are thrown at activists are mirror images of some of the criticisms that activists make at insiders. The devil is in the details," Nierenberg concludes.

Adds Davis: "Not all ideas floated by activists are equal. Nor are they always embraced by the other shareholders. Jamie Dimon survived an activist push quite well because the shareholders agreed with him, not with the activists. There have been several attempts by an activist to get on the board of Cracker Barrel and that has been repeatedly and overwhelmingly rejected. The point about activism, as opposed to the raider activism of the '80s, is this is not

about control, it tends to be about ideas and it ultimately comes down to whether the other investors support those ideas or not. And they don't always, but the tendency of shareholders to is really kind of a function of them thinking that the ideas of the activists are pushing are, on the whole, better than the ones management has to offer. The idea that management can say, 'well we've got this plan. It's going to take some time to implement. Just give us another two or three years,' there's really very little patience left with that kind of approach."

CONCLUSION

The current incarnation of activist investing is a powerful force in corporate governance in America today, with an increasing growth trajectory. The reputation of activists has been transformed from the reviled corporate raiders of the 1980s to the much-applauded new generation of shareholder advocates. Even critics of activism concede that it has produced healthy results for shareholders, although they remain skeptical over whether this is a short-term effect and will be detrimental in the long term. Likewise, critics worry about the distractions that activism puts on even well-managed companies, as well as their employees, customers, industries and communities. While popular and effective in the U.S., Europe has seen only a small amount of investor activism and the trend is unlikely to catch fire there for a variety of cultural, geographic and regulatory reasons. The only things seem possible to slow activism in the U.S. in the foreseeable future is another economic downturn or, less likely, a severe imposition of regulatory hurdles.

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