



Activist Investing

Drawbacks of Being a Lone Dissident on a Board of Directors, Starting an Activist Campaign and Targeting Retail Investors Are Themes at Activist Investor Conference

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By Jennifer Banzaca, *Hedge Fund Law Report*

On January 27 and 28, 2011, DealFlow Media hosted The Activist Investor Conference 2011 in New York City. Among the key topics discussed during the conference were: the key **strategies and objectives** of **activist investors**; how activists deal with being the lone dissident on a **board of directors**; whether and when to seek reimbursement for the costs of proxy contests; when to solicit retail investors for support in a proxy contest; how to contact objecting and non-objecting beneficial owners; and what budding activists should know about getting started. This article offers a comprehensive summary of the key points raised and discussed at the conference, and relays insights from Frank LaGrange Johnson, **Philip Goldstein** and others.

Activists' Objectives and Tactics

During a panel titled "A Review of the Objectives and Tactics of Hedge Fund Activists," speaker Alon Brav, Professor of Finance at the Fuqua School of Business at Duke University, discussed some of the objectives and tactics used by activist investors.

Brav noted that activist hedge funds generally act both as value investors and shareholder advocates. The typical strategy of an activist is to target undervalued firms and suggest options for improving the operational and financial aspects of the business, as well as its corporate governance.

Philip Goldstein, Founder of Bulldog Investors LLC, on a later panel agreed that activists are, by and large, value investors. "I think activists generally consider themselves to be value investors first. They tend to move into activism when they realize that management isn't motivated by wanting to enhance shareholder value but have other interests, including their own compensation." For more from and about Goldstein, see "**From Philip Goldstein: Salem-Style Justice is Alive and Well in Massachusetts**," *Hedge Fund Law Report*, Vol. 3, No. 33 (Aug. 20, 2010); "**Massachusetts High Court Rules that Website and Single E-Mail Communication to Massachusetts Resident Confer Personal Jurisdiction Over Philip Goldstein's Hedge Fund Company in Administrative Proceeding**," *Hedge Fund Law Report*, Vol. 3, No. 28 (Jul. 15, 2010); "**The Bulldog Decision: Implications for Hedge Fund Managers and the Massachusetts Securities Division**," *Hedge Fund Law Report*, Vol. 3, No. 32 (Aug. 13, 2010).

When targeting underperforming or undervalued customers, Brav noted that the objectives of activists include plans to change the business strategy to improve operations, profitability and efficiency; seeking a sale or merger of the target company; and making improvements to the company's corporate governance. By proposing actions to the board or via proxy contests, activists typically aim to reduce excess cash the company may have on hand; cut costs to boost revenues; increase dividends and share repurchases; pursue debt restructuring or recapitalization; or try to prevent or halt new equity offerings.

When suggesting improvements to a company's corporate governance policies and procedures, activists typically propose changes to the board structure, such as requiring directors to be independent or seeking better investor representation on the board. For more on corporate boards, see "[The Case for Professional Boards of Public Companies](#)," Hedge Fund Law Report, Vol. 4, No. 1 (Jan. 7, 2011). Additionally, measures to improve corporate governance often include improved disclosure and compensation policies.

A hedge fund that is under its high water mark may be more inclined to become an activist than if the fund were not under its high water mark. This is because in general, a hedge fund under its high water mark will not pay performance fees to its manager. See "[What Happens to High Water Marks When Managers Restructure Hedge Funds?](#)," Hedge Fund Law Report, Vol. 2, No. 43 (Oct. 29, 2009); "[How Are Hedge Fund Managers with Funds Under Their High Water Marks Renegotiating Performance Fees or Allocations?](#)," Hedge Fund Law Report, Vol. 2, No. 33 (Aug. 19, 2009).

Becoming an Activist

Any investor can become an activist investor, Bulldog's Goldstein said during the session, "Who Wants to be an Activist Millionaire?" "You can be an activist for the cost of a stamp, Goldstein said. "You buy \$2,000 worth of stock over the year and submit a proposal."

Goldstein said that even small hedge funds can launch successful activist campaigns, so fund or manager size is not necessarily an indicator of or restriction on success. For managers of smaller funds, Goldstein said activism requires creativity. "You have to be creative if you don't have the capital to buy a huge position and launch a huge proxy fight. Even if you don't own 5 percent of the company's outstanding shares, you can file a 13D and write a letter to the board. That letter could get picked up by the press, which could do a lot for your campaign. However, Goldstein cautioned that "being an activist is not for wimps." Companies have sued activist shareholders and generally have deeper pockets or insurance arrangements to cover legal fees, whereas fund managers bear legal costs themselves, directly or indirectly.

During his session, "Forward Industries: A Case Study in Small Company Activism," Frank LaGrange Johnson, Founder of hedge fund manager LaGrange Capital Partners LP, noted some key lessons he has learned from successful activist investing. The key lessons learned include:

- Be willing to run and transform the company yourself if you get on the board.
- Assemble your team. Johnson said, "Have the proper expertise and people who can help you, who have experience in the industry and in corporate governance and takeovers."
- Drive the process. Do not let the company dictate how the activist campaign will play out. Draft your own settlement agreement to force their hand.
- Evaluate the situation before initiating a proxy fight. "You need to make money," Johnson explained. "The risk/reward has to make sense."

- Negotiate. “Be willing to take half a loaf,” Johnson advised. “There are a lot of things a board can do to hurt you. They can increase management and board pay to effectively make the company less valuable and take other actions that could hurt your chances of success. Along those lines, Johnson noted, “Get the best deal you can. Having an attitude that things have to go your way 100% of the time is not a wise course of action and not a way to get to a deal done.”

Additionally, Johnson cautioned, “Take a position that is meaningful but not so big that owning the position, particularly an illiquid one, would cripple the fund.” See, e.g., “[Hedge Fund Restructurings Becoming a Viable, and Variable, Alternative to Liquidation](#),” Hedge Fund Law Report, Vol. 2, No. 6 (Feb. 12, 2009) (discussion of investment by Pershing Square IV in Target, the retailer).

While activism can be an effective measure to produce significant positive returns for an undervalued, underperforming company, it may not be as easy to launch an activist campaign at this time, Goldstein said. “It’s harder now to be an activist after the crisis because you need stable capital – you need a lockup. Investors now are skittish and want liquidity but activism doesn’t work that way. It takes time to acquire a position and you can’t have people pulling out money in the middle of a proxy fight.”

Being the Lone Dissident

For activist hedge fund managers that ultimately gain a seat on a company’s board of directors, the road to implementing changes within the company is not an easy task, particularly if the manager has only one representative on the board. According to panelists, activists that find themselves or their representative as the lone dissenting director must try to gain the support of their plans from fellow board members.

Dissident board members face an uphill battle, first in gaining a board seat then in gaining support of fellow board members, particularly in contested or heated board elections and proxy fights. Panelists on the panel, “The Perils of Being a Lone Dissident Board Member,” noted that some companies will try to paint the activist and its board nominees in a negative light. Even when the fight to gain seats on the board becomes particularly heated, and sometimes personal, panelists advised that in order to be able to work well with, and gain support of, fellow board members later, activists must stick to the issues and keep their focus on their outlines and plans for the company.

According to Richard Lashley, Co-Founder and Principal of PL Capital LLC, elections to company boards are much like political campaigns. Activists must do what it takes to win, but also keep the campaign focused on the issues. Eric Rosenfeld, Chairman and CEO of Crescendo Partners LP, agreed and noted, “if they raise the heat and get personal, we stay level and point out to shareholders what they are doing and that we’re sticking to the issues. The board needs to see we’re committed to our plan.”

“You have to focus on the facts and the economics,” added Behdad Alizadeh, Partner and Portfolio Manager at Pardus Capital Management LP. “Stick to your message about why and how you think you can improve company performance and shareholder value. Shareholders care about money. Once you move away from that message you lose the shareholders.”

However, Timothy Brog, Managing Director at Locksmith Capital Management LLC, noted that no matter how an activist hedge fund manager delivers his message about suggested corporate

changes, there is likely to be some company resistance to the manager seeking a seat on the board or, once on the board, trying to rally others to support the proposed changes. This is because “no director likes to be told they’re not doing a good job, whether you do it in a nice way or you do it in a nasty way. You have to point out that the company is not being run properly and they’re not doing what’s in the best interest of shareholders, and as a result, they’re never happy. You have to be prepared because your opinion is likely not going to be popular.”

However, as the lone dissenting voice, in order to effect any changes within the company, activist investors need to gain support of their ideas from other board members. Rosenfeld noted that when trying to find “like-minded people” on a board, he meets with each director individually as soon as possible after he becomes a board member. “It’s a good opportunity to sound out what they think should be improved at the company. This way they see you as a person and not just a crazy, unreasonable lunatic activist.”

Brog agreed that meeting with individual board members is a good tactic for finding directors who support your ideas. When meeting with the directors, activist investors should talk about the margins of the business. “The more prepared you are and the more work you do, the easier time you will have getting support. You can win them over by showing them you understand their business.”

Rosenfeld said it can take some time to get the other directors to agree to your way of thinking, but advised managers to “just keep going and stick with the issues. Eventually the board – or at least some of the directors – will come around. If you get one person to agree with you and let the dominoes start to fall, eventually you can get a majority or maybe everyone else on your side.”

Alizadeh also advised that when looking for allies on a board, the best approach is to seek out the “thought leaders.” Once the activist investor has the support of directors who have proposed changes and generally led the actions of the board, other board members are likely to follow suit.

However, until an activist is able to gain the support of the other board members, it is likely that proposals will not be approved, requests will be denied and meeting minutes may not reflect the activist’s requests, opposition or other opinions.

Brog said he has sent letters to the board and attached the letters to a 13D filing as a method of getting his firm’s opinions on the record when the meeting minutes did not accurately reflect the views expressed during the meeting. Additionally, Brog noted that if the board is omitting information from meeting minutes and other shareholder reports, activists can communicate with shareholders through a press release or letter to let them know the board is withholding information. “You’ve got to expose these people for what they’re doing. If they think what they’re doing is fair then they should let the shareholders decide.”

“If you’re one person out of five on the board you need some leverage and one way is to appeal to the public and shareholders,” Brog added. “Keep in mind, when there’s a staggered board or you decide to run a short slate, a year later you’ll have another proxy contest if things don’t get better. There are always options if things don’t improve.”

Sometimes, it is necessary for activists to remind the board of directors of their duties and the consequences of ignoring issues and information that could be important in making decisions affecting the company, Alizadeh noted. He further observed that it is important to record any objections you have made to ensure those objections are recorded. If the objections are not included in meeting minutes, activists can attach their own copy of meeting minutes to the

official copy so that there is a record of the objections or suggestions that were excluded from the official record.

Rosenfeld noted that no matter the circumstances, “it’s clear that when an activist gets on a board, it’s a new situation and a new board.” Singing to the tune of Frank Sinatra’s “New York, New York,” Rosenfeld noted that as an activist, “I’m tightening the screws . . . I’ll make you bums pay.”

Proxy Fees

Some public companies have bylaws to provide for reimbursement of expenses incurred by a stockholder in the solicitation of proxies for the election of directors. After launching a proxy fight to gain a seat on a company’s board of directors, activists need to determine if the company makes such reimbursements and if they want to seek such repayment.

Pardus’ Alizadeh said his firm does not seek reimbursement for proxy fees. “The minute the board feels they owe you for anything, you’re changing the philosophical principle of the discussion, which is that we’re here for a very specific reason. This company needs to be reoriented from an operational point of view, from a strategic point of view and often from a governance point of view. The minute you inform the board you have to be paid for various actions, you’re changing the topic.”

Locksmith’s Brog said it might be wise to defer requests for reimbursement. “When you’re going into that board room for the first time and you’re trying to win people over, it might not be a bad idea to defer that request for three or six months.”

Although not part of the panel, Bulldog’s Goldstein said, “I think it’s better to raise that issue right away so everyone knows it’s on the table.”

Rosenfeld agreed, adding, “It’s certainly fair to get reimbursed. If the reimbursement is not part of a settlement, you have to look at it as trying to put the animosity behind you. If you are seeking reimbursement, do it right away. If you defer for three to six months, board members are going to ask why you’re bringing up the issue at that time.”

Targeting Retail Investors

When launching a proxy contest, an activist can reach out to other shareholders to try to solicit support for its proposals. While activists generally will reach out to other institutional investors, there may be times when it could be beneficial to reach out to retail investors. However, doing so can be difficult because activist managers may not be able to directly contact beneficial owners of securities held in “street name” with broker or bank intermediaries if they object to disclosure of their identities to the company – known as “objecting beneficial owners” or OBOs. While the company may contact non-objecting beneficial owners (NOBOs), SEC rules require that proxy materials be forwarded to them by the intermediaries. The retail investors, who can represent a significant portion of the voting power of public companies, typically have low voting rates. If an activist can entice the retail investors to vote, it could help swing the favor of the proxy contest to the activist.

Jeremy Fielding, Managing Director at Kekst & Company, said activists should try to identify as many NOBO investors as possible through broker-dealers. It is important that when getting a

list of shareholders that the lists are current because activists will not want to waste time contacting people who no longer hold shares.

When deciding whether to approach retail investors, Laura Bissell, Managing Director and Head of the Mutual Fund Group at proxy solicitation firm Okapi Partners LLC, explained that “with any campaign, you have to look at the demographics of your shareholder base and determine if it makes sense to engage the retail population. If you have an investor base that is inherently institutional, retail investors likely will not impact the vote at all and therefore it would not make sense to approach the retail population. On the flip side, if you have a shareholder base that has a lot of retail, absolutely it would make sense. Then you have the middle road – a proxy contest in which the institutional vote is closely split. In such cases, if you can go to the retail vote and get those few extra percentage points, then it would make sense in that context.” For more from Okapi Partners, see “[How Will Changes to Proxy Access and Broker Voting Rules Impact Activist Hedge Fund Investors?](#),” Hedge Fund Law Report, Vol. 2, No. 3 (Jul. 29, 2009).

While some activists may be reluctant to approach retail investors because they believe them to be “pro management,” Amy Goodman, a Partner at Gibson, Dunn & Crutcher LLP, said that it is wrong to assume retail investors support current management, particularly in today’s economy.

Bissell said the primary way activists can reach out to retail investors is via mail, although this is not the most effective method of contacting investors. “The telephone is a great way to reach out to retail shareholders if you can get them on the phone. However, we are seeing the use of social media, like YouTube and Twitter, which really haven’t been used before, to leverage the retail campaign.” Additionally, Bissell suggested that if a company has engaged in a campaign to solicit the retail vote, activists should do the same.

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