

*The Board's Role in Defending
Against Hostile Bids*



THE BOARD'S ROLE IN DEFENDING AGAINST HOSTILE BIDS

Hostile bids comprise an increasingly significant portion of M&A volume and boards of directors must be prepared to defend against them. In 2006, more than 10 percent of global M&A activity was hostile. Commentators expect that number to rise due to increased shareholder activism and market dynamics, which have ushered in a new era of aggressive hedge fund acquirers that control vast pools of capital. Activists are well-versed in how to engage in hostile activity, and often echo the sentiments of core shareholders. To minimize the risk of its company becoming the target of a successful hostile bid, a board of directors must put in place preventive measures that will allow the company to prepare for and defend against hostile activity. Boards always must keep in mind that a hostile bid presents a serious risk that control of the company will change (often with little to no premium for the shareholders) and that being unprepared to defend against unsolicited bids significantly increases that risk.

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "The Board's Role in Defending Against Hostile Binds" was a featured breakout session. Moderated by Steve Vazquez, partner, Foley & Lardner LLP, the panel included Bryan Armstrong, partner, Ashton Partners; Justin Friesen, executive director – M&A, UBS Securities LLC; Richard Grubaugh, senior vice president, D.F. King & Co., Inc.; Charles Hansen, executive vice president and general counsel, Saks, Inc.; and Cary Kochman, managing director, UBS Securities LLC.

Shareholder activism has exploded in recent years and activists' strategies are frequently successful. Activists are well-prepared before making an investment – e.g., they know the target company's bylaws, its shareholder base and its trading environment, and they have a detailed plan that has been successful in other situations. In addition, activists identify and capitalize on the dissatisfaction of core shareholders, particularly with respect to strategic plans that those shareholders do not believe are rational or defensible.

Preparation for an unsolicited bid is critical to a company's survival. A public proposal results in enormous pressure on the target company's board and management team. A hostile bid that escalates into a proxy battle can cause irreparable harm to the target company, regardless of who "wins." And the public pressure of a hostile bid can constrain the flexibility of the target company to pursue growth ambitions if those ambitions are at all controversial.

A board can take several preemptive steps to prepare for a hostile bid:

- **Recognize early warning signs of activist movements.** Activist movements are detectable well before they rise to the level of a tender offer, proxy fight, or public or private "bear hug." Boards should look for and take note of more subtle indicators of activism, including the use of trading and hedging strategies to increase position and leverage, aggressive questioning on conference calls, and accumulations of increased stake in the company. More overt but sometimes overlooked signs include an increasing number of shareholder proposals, "withhold vote" campaigns, and reports of interviews of customers and employees.
- **Demand better shareholder intelligence.** Boards should solicit regular feedback from all types of shareholders to tease out areas of discontent, detect potential



points of company vulnerability, and determine the support level for the direction of the company.

- **Gain support from third party influencers.** Proxy advisory firms can influence significant numbers of outstanding shares. They also can evaluate and compare strategic plans from company management and dissident groups. Media can push a steady stream of positive press releases about company direction and strategy.
- **Articulate and demonstrate a well-vetted corporate strategy.** Activists see the need for change, which hinges on the perceived absence of a reasonable alternative to an activist's proposals. Boards should communicate key priorities for management and provide realistic benchmarks and milestones that investors can use to evaluate management's execution progress. Boards cannot let historical company performance speak for itself or assume investors have unabated confidence and trust in management.
- **Make proactive operation decisions.** Boards should look closely at troubled areas of the business and consider making tough decisions to address problems identified before those problems become an opportunity for activists. For example, a board could consider selling underperforming business units or reorganizing. In addition, a board could decide to use cash balances for reinvestment in the business, share repurchases or strategic acquisitions.
- **Establish a defense working group.** Successful activism often involves an element of surprise, but boards can mitigate the impact of unanticipated moves by establishing a "defense working group" of management and outside advisors. Investment bankers can identify and prioritize strategic alternatives, prepare a "response playbook" for different unsolicited approaches, identify potential unsolicited suitors or hedge fund aggressors, assess the impact of a change of control on the company, and review and analyze recapitalization alternatives. Legal counsel can inform directors of their duties in the context of third party solicitations, provide corporate law and antitrust analyses, and identify company disclosures that might cause a potential acquiror to look elsewhere. A shareholder relations team can handle financial public relations, make contacts with research analysts, institutional holders and hedge funds, work to ensure the security of all forms of shareholder lists, monitor trading activity, prepare internal employee communications programs, and prepare a response to an activist proposal that identifies alternatives to the proposal to satisfy investors. The CEO can (and should) act as the sole spokesperson for the company on director independence and takeover issues, and can prepare company responses to various unsolicited approaches.

Once hostile activity has begun, boards should not avoid communication with the activist. Instead, the company should keep the negotiating door open at all times. At the same time, boards should try to control the negotiation process as much as possible – e.g., by converting the unsolicited bid into a friendly negotiation or by controlling the company's image through a press release that defines the conflict and brands the "raider" in the public domain.



Finally, board members must keep in mind their duties in the context of unsolicited overtures. The business judgment rule directs courts to defer to the decisions of boards of directors, but those decisions must be made with “due care” by disinterested and independent directors. Board members must be able to demonstrate that they took steps to ensure that they were adequately informed to take the action under consideration, that they devoted sufficient time to the consideration of relevant information, and that they rationally believed the action taken was in the best interests of the corporation.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.