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Institutional Shareholder and Hedge Fund Relations and Issues

2008 NATIONAL DIRECTORS INSTITUTE

INSTITUTIONAL SHAREHOLDER AND HEDGE FUND RELATIONS AND ISSUES

INTRODUCTION

"Institutional Shareholder and Hedge Fund Relations and Issues" was a featured breakout session at the seventh annual National Directors Institute hosted by Foley & Lardner LLP on March 6, 2008, in Chicago. The session was co-moderated by Phillip M. Goldberg, Partner, Foley; John K. Wilson, Partner, Foley; Richard H. Grubaugh, Senior Vice President, D.F. King & Co., Inc.; Emily McNeal, Executive Director, UBS Securities LLC; and Gordon McCoun, Vice Chairman, FD/Ashton Partners. Panelists included Jeffrey A. Brown, Senior Corporate Counsel, Motorola, Inc., and John Palmer, Co-Founder, PL Capital LLC. The panel participants presented a balanced discussion of the interaction between a public company and an activist shareholder, focusing on the strategy of the company preparing for and responding to contact from a hedge fund as well as on the hedge fund's expectations of the company's management and board of directors.

In recent years, the ability of hedge funds and other activist shareholders to influence a company's management and board of directors steadily has increased. From a hedge fund's perspective, communication and access are key. A company that blocks access to requested information about its business or forbids communication with key members of management or the board of directors may find itself in a subsequent proxy contest with an activist shareholder. Alternatively, a company that is adequately prepared both procedurally and substantively to effectively respond to contact from a hedge fund or other activist shareholder is significantly better positioned to manage the demands of such shareholders and to generate a positive outcome for the company.

PREPARATION FOR COMMUNICATION WITH HEDGE FUNDS AND ACTIVIST SHAREHOLDERS

IDENTIFICATION OF HEDGE FUNDS AND ACTIVIST SHAREHOLDERS

Because activist shareholders and hedge funds are becoming more adept at influencing corporate decision making with their increasing power and sophistication, a company's management and board of directors should be continuously apprised of the makeup of the company's shareholder base. Companies also should attempt wherever possible to identify relationships or cooperative interaction among shareholders and should monitor unusual trading activity to identify those hedge funds or other activist shareholders that may be positioning themselves to initiate a dialogue with the company. Some of this information can be obtained through the use of a stock-watch service or through a company's regular review of shareholder filings with the U.S. Securities and Exchange Commission (SEC) on Schedule 13F or Schedule 13D.

An awareness of the shareholder base also may enable a company to recognize how certain shareholders historically have attempted to effect corporate change, and to identify which of its shareholders are presently active with respect to other companies.

ANTICIPATION OF SHAREHOLDER CONCERNS

A company — including its management and board of directors — that is able to anticipate the specific concerns and expectations of activist shareholders and hedge funds by demonstrating an in-depth understanding of its business performance is more likely to be successful at minimizing any negative impact that may be caused through interaction with such shareholders. The panel noted that a board of directors should be in a position to critique the company's business performance in order to identify weaknesses that might be targeted by hedge funds or other activist shareholders. A company's investment banking firm can be of assistance to the board of directors as the board considers where the company is positioned in the marketplace. An annual presentation from an investment banking firm, detailing the current activist environment and the market's perception of the company on a macro level, is advisable at least annually. Outside counsel also should participate in the annual review, which should include an evaluation of the company's takeover defenses.

Maintaining a board of directors that is engaged and informed can go a long way in demonstrating to shareholders that a company is serious about its overall performance and about how the company is perceived in the marketplace. In contrast, if a company's board of directors possesses only limited knowledge about specific aspects of company performance, such as return on equity, or about key facts of a company's management, such as executive compensation, activist shareholders may sense an immediate need to aggressively seek to bring about corporate change.

Similarly, in many cases, shareholder activism is essentially arbitrage. Therefore, a company's management and board of directors should evaluate on an ongoing basis how the company is being valued and what the potential targets may be for hedge funds and other activist shareholders interested in generating additional value.

PROCEDURAL PREPARATION FOR DIALOGUE WITH ACTIVIST SHAREHOLDERS

Preparation for contact from shareholders can help a company more effectively deal with a hedge fund or other activist shareholder. As a preliminary matter, a company should have in place a team composed of both external and internal representatives. The team should consist of the company's key officers, including the chief executive officer, chief financial officer, general counsel, investor relations personnel, and board of directors, along with the company's outside counsel, investment bank, proxy soliciting firm, and financial public relations firm. However, it is important for management to approve and implement the strategy for dealing with activist shareholders. The members of the team should focus on preparation, strategy, and the direction of the company as they plan and coordinate their approach to communicating with the activist shareholder as well as with the broader shareholder base.

Because it would be impractical to have the chairman of the board of directors or a high-level member of management respond directly to the concerns of each individual shareholder, it is most efficient for a company to channel shareholder communications through a single point of contact, typically the company's investor relations representative. When communications from shareholders are received, this person can make a determination — based on the shareholder's size, the length of time that the shareholder has held shares in the company, and the substance of the shareholder's concerns — as to whether contact with "C-level" management is appropriate.

COMMUNICATION

Openness and communication with shareholders are key — it is seldom a bad idea to listen to the concerns of hedge funds or other activist shareholders. Because it is common for activist shareholders to demand meetings with the chief executive officer, chief financial officer, or other senior management, a company's response team should have a plan in place for how to respond to such requests. In particular, a company should understand the varying investment objectives and the substance of information sought by its activist shareholders, so that it can communicate an effective response. Maintaining open lines of communication with hedge funds and activist shareholders while simultaneously retaining an appropriate level of control over the direction of the company may increase a company's likelihood of success in dealing with such shareholders.

HEDGE FUND AND ACTIVIST SHAREHOLDER EXPECTATIONS

ACCESS TO INFORMATION AND KEY MEMBERS OF MANAGEMENT

Mr. Palmer noted that his fund typically will contact a target company before exceeding the five-percent ownership threshold and filing a Schedule 13D with the SEC. The expectation of many hedge fund managers and activist shareholders is that a member of senior management (or someone whose authority and responsibilities significantly exceed those of the investor relations representative) will be made available to listen to the hedge fund's point of view. From a hedge fund's perspective, what is communicated at this first meeting with management is crucial. If a company demonstrates a willingness to communicate regularly and substantively, the hedge fund may be more inclined to work with the company prior to going public. Frequently, to the extent that a company engages in and continues such a dialogue over time and is responsive to a shareholder's concerns, the company may receive the benefit of the doubt from an activist shareholder. In contrast, if the company puts up roadblocks to information or terminates communication, the activist shareholder may be more eager to go public.

MEETINGS WITH THE BOARD OF DIRECTORS

Activist shareholders and hedge funds may request direct communication with the entire board of directors if they believe they have been shut out by the company. One of the hot-button issues in this context is executive compensation. Denying a shareholder or hedge fund access to the compensation committee chairman may damage the shareholder/company relationship. Additionally, in the event that a hedge fund is permitted access to a company's board of directors, it expects both independent directors and management directors to demonstrate a detailed understanding of the company's business operations, market performance, and forward strategy.

CONFLICTING VIEWPOINTS

The panel noted the following issues that highlight the contrast between the interests and goals of a company and those of hedge funds and activist shareholders.

ACCESS TO INFORMATION

Companies may not want to consult with hedge funds and other activist shareholders as frequently as requested by such shareholders. In contrast, hedge funds may have identified immediate concerns about the company's performance or management, and may want sufficient access to key personnel and information in order to be assured that those concerns are being addressed adequately.

HEDGE FUNDS AS ACTIVISTS

Mr. Palmer noted that it is important for companies to understand that not all hedge funds are activists all of the time. However, companies may be of the view that when an activist shareholder approaches the company, it is too late for the company to respond in a way that satisfies the shareholder.

GLOBAL MARKETS

Hedge funds and activist shareholders may push a company in a particular direction without understanding that global market conditions fundamentally prevent the company from going in the direction suggested. The best method for overcoming this conflict is, not surprisingly, adequate and frequent communication between the company and its shareholders.

LONG-TERM VERSUS SHORT-TERM RETURN ON INVESTMENT

Companies rightfully should be wary of proposals from hedge funds that will advance only the short-term interests of shareholders. The panel noted that hedge funds may hold the stock of their portfolio companies for several years with the intention of growing the company by expanding product or service offerings, by reducing expenses, or by increasing market share. A company's dialogue with a hedge fund or activist shareholder should involve attempts to discern whether the shareholder is seeking long- or short-term gains.

FOR MORE INFORMATION

For more information on this session or the seventh annual National Directors Institute, visit Foley.com/ndi or contact the moderators and panelists directly.

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