MAYER BROWN ROWE & MAW

Securities Update

Hedge Fund and Institutional Shareholder Activism

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In the past year, hedge fund and other activist institutional shareholders have significantly increased their campaigns against publicly traded companies.

From the perspective of publicly traded companies, these shareholder activists can be a very disruptive and unpredictable force. These shareholder activists can be generally placed in two groups. First, there are the hedge funds and certain other shareholder activists, whose objective generally is to increase shareholder values quickly through a corporate sale, restructuring or other fundamental corporate change. Corporate governance changes are typically not that important to these activist shareholders, since they generally do not believe (with some academic corroboration) that corporate governance changes result in increased shareholder values. Second, there are state, union and certain other institutional investors and institutional shareholder advisory services where campaigns usually correspond with corporate proxy season and whose objective is to push corporate governance changes at companies.

This memorandum (i) notes the recent growth of both types of shareholder activists, (ii) discusses when the interests, incentives and objectives of certain shareholder activists may differ from each other and from those of general shareholders, (iii) discusses corporate responses to shareholder activists, and (iv) cites some important legal issues that relate to hedge fund and similar shareholder activists' campaign to pressure for fundamental corporate changes.

Companies Should Recognize that Shareholder Activists Are Increasing in Amount, Size and Effort

There are at least 90 corporate activist hedge funds worldwide today in comparison to about 40 three years ago. These activist hedge funds, and hedge funds generally, have grown significantly in the past 3-5 years. Some mainstream institutional investors, including mutual funds (such as Franklin Templeton, Fidelity and Tweedy Brown), and pension funds (such as CalPERS), are supporting activist hedge funds. Traditional institutional investors are directing some of their assets to more activist hedge funds. As the lines between hedge funds and private equity funds blur – especially as to loosening restrictions in large private equity funds on hostile acquisitions or public share acquisitions – more of the large private equity funds are also looking to acquire or take private companies facing shareholder activists. It is not just the frequency of aggressive moves by hedge funds into corporate governance that has attracted attention, but the high rate of success they have had. In 2005, The Altman Group tracked 20 instances of shareholder activism involving hedge funds. In 15 of those cases, the target company conceded or was forced to accept to some degree the demands of the shareholder activists. Shareholder activists pursuing corporate governance reform are pushing about 120 majority vote shareholder proposals in the 2006 proxy season.

When Can the Objectives, Interests and Incentives of Shareholder Activists Differ From Those of General Stockholders?

Hedge Fund Activists as the Shareholder Champion?

Activist hedge funds, with their substantial expertise, resources and financial and legal ability to commit large amounts of capital to single company investments and therefore profit from shareholder pressure on that company can be viewed as the shareholder champion long sought by corporate governance advocates. In this view, hedge fund activists are the antidote to the corporate governance problem of management, separated and insulated from the interests of share owners, pursuing management's own interests (or imposing "agency costs" on their shareholder principals) instead of the interests of the share owners (their "principals"). Dispersed uncoordinated public shareholders have often found coordinated action to counter management too difficult or expensive (the "collective action problem"), limited by regulation and too unrewarding in weighing the cost of activism against the benefit to the particular shareholder (the "rational apathy" problem) even if substantial benefits might be available to all shareholders as a group (the "free rider problem"). Showing the promise of hedge fund activism that can increase shareholder values for the benefit of shareholders generally, activist hedge fund shareholders have recently forced some fundamental changes, including corporate sales, discontinued acquisitions and spin-offs, which have generally increased share values for all shareholders and catalyzed shareholder activism generally.

Hedge Funds Enjoy Benefits Over Traditional Institutional Investors.

Hedge funds may be able to be more activist because they are relatively lightly regulated. Traditional institutional investors, in particular mutual funds and ERISA funds, are subject to a number of regulatory constraints not imposed on hedge funds which limit their ability and incentives to monitor portfolio companies. Mutual funds are subject to special disclosure requirements not applicable to other types of investors. Most importantly, mutual funds must supply to their shareholders, and thus to the public, a semi-annual list showing the amounts and values of the securities they own. Mutual funds must disclose how they voted any shares of their portfolio companies. These requirements make it harder for mutual funds to accumulate positions in portfolio companies without such companies, and the market at large, becoming aware of their activities. This can discourage mutual funds from taking sizeable positions in portfolio companies. In addition, mutual funds must comply with diversification requirements in order to qualify for significant tax benefits in subchapter M of the Internal Revenue Code. Accordingly, 50% of the assets of a mutual fund are subject to the limitation that the fund may own no more than 10% of the outstanding securities of a portfolio company and that the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund. Open-end mutual funds, by definition and by statute, must stand ready to redeem their shares at the request of any shareholder at short notice. The redemption price of these shares is based on the fund's net asset value and mutual funds are required to determine their exact net asset value on a daily basis. Therefore, it presents quite a challenge for such a fund to ensure that large positions in companies, which may not be easy to liquidate, are correctly valued at all times. In addition to the practical limitations on liquidating large positions there are regulatory constraints to consider if a large stake in a company causes the investments to become an affiliate or insider as to the company.

Hedge funds are not subject to the same diversification obligations, nor are they subject to the special mutual fund reporting requirements. Hedge funds can face quarterly redemption pressure from investors, although a growing number of hedge funds are confronting this redemption pressure by requiring investors to lock-up and forego redemption rights for several years. The recent hedge fund adviser registration rule may actually tend to promote the development of hedge fund activism. In order to remain exempt from registration under the adviser registration rule, hedge fund managers have required two-year lockups from their investors. If a manager has obtained such a lockup, it permits the manager to engage in longer term investment strategies, which would appear to allow for more illiquid investment strategies, including larger block positions in public companies.

When Can the Interests of Hedge Fund Activists Differ From Those of General Shareholders?

Hedge funds, of course, are obliged to maximize the investment returns and profits of their own hedge fund for the benefit of their hedge fund investors and are effectively motivated by the personal profit incentives embedded in a hedge fund structure. Under this circumstance, profit maximization by hedge fund managers in relation to its investment in a particular company may conflict with the

profit-seeking objectives of other shareholders of that company These conflicts can arise when hedge funds have a shorter-term trading horizon than other shareholders, when hedge funds have conflicting interests due to other investments they have in their portfolio, or when hedge funds become bidders for control.

1. **Fee Structure.** The typical hedge fund manager/partner has something like a "2/20" arrangement with its own investors (i.e., 2% (sometimes down to 1 ½ %) of annual management fees on invested capital and 20% (sometimes more) of annual profits. Sometimes, the annual profit participation is provided only after prior years' losses are recouped or a preferred return to investors hurdle is surpassed. Other market investors, such as mutual funds, pension and ERISA funds, most asset managers and individual investors do not, and sometimes are not permitted to have this profit structure, especially the 20% annual profit participation. This hedge fund profit structure can motivate hedge funds to pursue large and quick returns from investments. Because hedge fund managers often have little personal investment in their funds, they are subject to incentives aiming at large upside gains (where they get 20% of profits) with little personal downside (where they do not personally suffer much loss). If there is a preferred return hurdle before the 20% profit participation, the incentive for quick profits is increased (since profits realized over time may be largely absorbed by the preferred return to investors). This is akin to employee options, where the option provides large upside opportunity and little downside risk. This incentive structure differs from the ordinary investor, who must balance the risk of personal losses on mutual fund investments as compared to regular profits on these invested funds.

2. **Short Term.** In view of their incentive structure, hedge funds are the archetypical short-term investor. While there are surely differences among hedge funds, their high relative trading volume – they account for one-third to one-half of daily trading activity, but only for 5% of total assets – and their frequent use of derivatives, which often are inherently short term financial instruments –indicates that hedge funds are primarily oriented to investments with relatively short-term payoffs. Hedge funds typically have a shorter time horizon than other investors, and what is good for a quick trade is not always good for longer-term interests. For example, hedge funds have actively pressured management to use cash in the short term to buy back company stock. While such actions might cause a near-term rise in the stock's price and serve those seeking a quick profit, greater fundamental values and, ultimately, greater appreciation might develop if the firm used the money instead to upgrade its physical plant or to make a judicious acquisition. Hedge funds with a short term focus may benefit by pressuring management to abandon higher – but hard to value – projects in favor of more easily valued projects. This pressure could injure the interests of the long term shareholders who are relatively indifferent to short term fluctuations in stock price so long as the market accurately values the assets over the long term.

3. **Derivatives.** Hedge fund investors, far more often than other investors, use sophisticated hedging strategies. There are now numerous techniques, including the use of equity derivatives and other financial contracts, that allow shareholders to alter the economic characteristics of their ownership interest in a firm's shares relative to general shareholders (shareholders that have not engaged in any derivative transactions with respect to their shares). The result is that shareholders using hedging strategies can effectively decouple their interests from those of typical long-term investors. To the extent that hedge fund investors do not share the same economic interests in a share as other investors, their interests will not naturally coincide.

   This was witnessed in the vote on the proposed acquisition of King Pharmaceuticals by Mylan Laboratories. The price of King's shares shot up after the merger was announced, but the price of Mylan's shares dropped significantly. Some observers and long-term institutional investors in Mylan believed the deal with King was short-sighted on the part of Mylan's management and would be detrimental to Mylan. A hedge fund headed by Carl Icahn stepped in and took a significant long position in Mylan and began agitating to defeat the deal with King, effectively making a bet that Mylan's shares would recover their value if the King deal could be stopped. A hedge fund named Perry Corp. had a significant long position in King's shares and stood to lose if the deal with Mylan didn't go through. To try to counteract the opposition to the deal from Icahn and other Mylan shareholders, Perry acquired a voting stake in Mylan of almost ten percent, but used a hedging strategy to swap away most of the economic risk associated with the ownership of those shares.

Mylan and King eventually abandoned the merger, but this aggressive activist strategy pursued by Perry created a stir. Icahn's group eventually dropped a lawsuit it had brought against Perry Corp., but the Securities and Exchange Commission (SEC) pursued an enforcement action against Perry based on the disclosures Perry had made in a Schedule 13D it filed at the time of the transaction. The SEC action appears focused on whether Perry disclosed enough details about its hedging strategy but does not appear to challenge the merits of the underlying transactions themselves.

This example of a separation of the economic interest from the voting interest is a stark reminder of the limits of pure shareholder democracy as a model for corporate governance when shareholders do not fit the classic model of "buy and hold" investors whose interests are closely aligned with long-term corporate success.

4. **Diversification.** Hedge funds can and often do have much more concentrated ownership in companies than the broad market ownership of mutual funds and other institutional investors. Hedge funds, then, will focus their profit maximization on tactics furthering particular company performance, even if these tactics have external costs to the overall market or industry. In contrast, in deciding how to exercise their power as shareholders, more institutional owners must make decisions in light of their substantial diversification. This diversification minimizes their exposure to firm-specific risk but exposes them to overall market risks and to single company risks that spillover and are externalized to companies in broad segments of the market. For both reasons, hedge fund shareholders are likely to have objectives for corporate decisionmaking different from their less-diversified counterparts. They are likely to be more sensitive to tactics at a particular company that may impose external costs or risks to other companies in an industry.
5. **Publicity Value.** Hedge funds may well view the publicity associated with public activist strategies as cheap and effective publicity for their own personal profile or capital raising. The publicity associated with a particular company campaign may draw investors into a company, and permit the activist hedge fund with a quick, profitable exit. Or that publicity may build profile and brand value for the hedge fund and therefore attract more investors to the hedge fund. In each case, a publicized campaign could provide such significant benefits to the activist hedge fund not shared by the other shareholders of the target company.

Corporate Responses to Shareholder Activists

Consider Potential Corporate Vulnerabilities

Companies should assess their own corporate vulnerabilities to shareholder activists, just as shareholder activists, in turn, will look carefully at the companies for vulnerabilities. For example:

1. Market studies have shown that corporate targets of hedge fund activists typically are small-to-medium capitalization companies that are underleveraged and/or have significant cash holdings and have an underperforming stock (or stock price multiple) as compared to market or comparable companies or a relatively low market valuation as compared to asset values. With such companies, financial restatements or shareholder lawsuits often become the catalyst for shareholder agitation.
2. The corporate targets of corporate governance activists are often companies that rate relatively poorly against the corporate governance "check lists" of groups such as Institutional Shareholder Services ("ISS") or the Council of Institutional Investors ("CII") or can be singled out in view of certain features that have attracted their attention in 2005 and 2006, including executive compensation and severance, poison pills and classified boards.
3. Are all directors of the company elected annually, or is there a classified board? If there is a classified board, which directors (lead director, CEO, audit committee or compensation committee chair) are up for election and therefore vulnerable?
4. May directors be removed without cause?
5. Does the company have a "majority vote" by-law provision or corporate policy, or is it considering one this proxy season?
6. Has ISS, CII or other institutional shareholder advisory services targeted the company now or in the past? In 2005 and especially 2006, executive compensation and severance resolutions, as well as continuing focus on classified boards and poison pills, have become significant issues for these institutional advisory services that can be used to rally against the company and management.

7. When can shareholders take action? Can shareholders call special shareholder meetings and what actions are permitted to be proposed by stockholders and/or considered at special meetings?
8. May shareholders act by written consent?
9. Is the shareholder base weighted towards potential shareholder activists, hedge funds and other pension or mutual funds which have a reputation of being receptive and supportive of shareholder activists? In looking at the institutional investors, do they have stockholder voting policies or do they have a practice of deferring to the recommendations of ISS?

Determine the Shareholder Activist Objectives and Agenda

A company's response to shareholder activists requires an initial assessment of their objectives and agenda, which can point to different responses and tactics. Hedge fund activists are generally focused on pressuring for a corporate sale or other fundamental corporate changes in order to quickly increase shareholder values. They often do not place much value on corporate governance campaigns, except to the extent the campaigns make the sale of a company easier (e.g., by repealing a poison pill) or exert general pressure on incumbent management who oppose the objectives of corporate management. Institutional corporate governance campaigns, on the other hand, are generally not focused on forcing a corporate sale. It is important to make this assessment quickly, and to be flexible in changing responses and tactics as the circumstances and objectives change and as other investors and the market react to the shareholder activists. Initially, a company might consider:

1. Are there hedge fund activists aiming at forcing a sale of the Company or a sale or spin-off of significant business or a major recapitalization? The corporate response will be similar to a takeover defense.
2. Are the shareholder activists pursuing a proxy contest or other change in corporate directors? These campaigns can be initiated by either hedge fund activists seeking to pressure a board or by corporate governance advocates. In either case, the corporate response will also be similar to a takeover defense, especially since board instability can put a company "in play."
3. Are their corporate governance shareholder activists pursuing a shareholder resolution or by-law or corporate policy change that doesn't relate to a fundamental corporate change? In 2006, the focus of shareholder groups generally is executive compensation, especially equity-based compensation, director compensation, eliminating poison pills, declassifying staggered boards, majority vote provisions and shareholder access to director nominations. Here, the corporate response may be different, as often the protagonists are pension funds, unions, corporate governance activists or their advisors, such as ISS and CII. Nevertheless, a company should be cognizant that shareholders mobilized over such corporate governance issues may attract, or be receptive for tactical reasons to, hedge fund activists pursuing other agendas including fundamental corporate changes.
4. What is the history and background of the shareholder activists? This may reveal a pattern of past tactics. Would an investigation into the shareholder activist reveal circumstances suggesting that their interests are not consistent with or even different from the interests of general shareholders? Identifying the incentives and interests of the activists, especially when they may differ from the interests of general shareholders, may both provide insights into appropriate responses and response tactics.

Shareholder Activists Pursuing Corporate Governance

If the shareholders are pursing corporate governance changes, then companies are well-advised to sit down and discuss the corporate governance proposals and reach a settlement that does not result in a shareholder referendum. ISS is increasingly responsive to such settlements, most recently with corporate policies. Increasing clarity around Rule 14a-8 and related no-action letters and the results of proxy solicitations at other companies provide a relatively clear set of expected results for companies and shareholder activists to guide settlement efforts. For these reasons, the past few years have generally witnessed a decline in majority-approved shareholder proposals and withhold vote recommendations largely because of companies electing to pursue corporate governance changes or principles through private settlement with shareholder activists or separate corporate initiative rather than to confront the time, expense and negative publicity associated with a shareholder campaign.

Responding to the Activist Approach Relating to Fundamental Corporate Changes

Hedge fund and other shareholder activists are increasingly seeking to maximize their own profits through demands of

a company to sell itself or to sell a significant business to increase dividends or share buy-backs, to add special investor board seats and to remove change of control protections (such as poison pills and staggered boards). If a company is confronted with such activists, a company should consider:

1. A company and its board typically is not obligated to meet, discuss or negotiate with a shareholder activist nor investigate or pursue any sale of the company, spin-off or other fundamental change proposed by a shareholder activist if the company has not already put itself in play.
2. A company and its board typically is not obligated to disclose that it has been approached by an activist, and can respond to public inquiries about the activist approaches with the customary "no comment" response, unless the company has become subject to an affirmative disclosure duty by virtue of prior public denials, insider leaks or insider trading. However, shareholder activists may seek to independently publicize their activities as part of their strategy, which may, as a practical matter, force the company to respond publicly in some way.
3. Tactically, a company should take the opportunity to listen to a shareholder activist without responding to it in order to learn as much as possible about the shareholder activist and its objectives, resources and investor support and in order to keep open lines of communications. ("We will listen and get back to you if appropriate.") Listen politely and don't respond to the shareholder activist. The board should be notified, and will likely determine the appropriate corporate response.
4. Putting aside legal obligations, a company may nonetheless tactically determine to meet, discuss or negotiate with a shareholder activist or to disclose an activist approach and corporate response. If a company pursues this course:
   - When meeting with shareholder activists, a company should consider requesting a confidentiality agreement (although it's unlikely to be provided) and in any event should be careful not to disclose material non-public information in order to avoid tipper/tippee insider trading and selective disclosure/Regulation FD concerns. The company should consider carefully whether the fact of the meeting itself is material, and likely to be disclosed by the shareholder activist in regulatory filings or as publicity to pressure the company or will otherwise be leaked. Any of these considerations may point towards voluntary disclosure by the company.
   - When publicly responding to shareholder activists, the corporate response should be carefully structured and choreographed, and customary investor relations practices (including Regulation FD disclosures and Form 8-K filings) should be carefully followed.
   - In responding, companies should be sensitive to the reactions of the debt providers and debt markets, as well as their rating agencies, which may interpret corporate or activists disclosures as portending corporate transactions that may alter the company's credit rating or worthiness.
   - The board should be closely advised as to any meetings, discussions and responses, especially since shareholder activists will likely seek to independently contact or otherwise pressure directors.
   - A company should be very careful that its communications and conduct, unless intended, do not create the market impression of a company that is for sale, "in play" or vulnerable and reactive to shareholder activists.

Create a Corporate Team to Respond

1. As in a takeover situation, a corporate team consisting of senior executives, counsel, financial advisor, proxy/investor relation firm and public relations advisors should be created to advise the company and interface with the shareholder activists.
2. An executive who is authorized and capable of listening and responding on behalf of the company to shareholder activists should be identified.
3. The availability of board members (or a board committee) for quickly called, special meetings should be confirmed.

Prepare the Board

1. The board should be informed about an approach by a shareholder activist and consulted or involved in approving and formulating the response.
2. As in a takeover situation, maintaining an informed, confident and unified board is important. Shareholder activists will seek to identify and exploit differences among management, directors and independent directors.
3. Also, as in a takeover situation:

- The company and board should review basic corporate, financial and operating strategies of the company, and the issues associated with corporate and financial fundamental changes, such as recapitalizations, spin-offs and divestitures, which are currently pursued by shareholders activists. The directors should be aware of alternative corporate strategies proposed by their advisors, analysts, commentators and market participants for the company and comparables to the company, and ask management to inform the directors as to their viability for the company.
- The board should receive advice and periodic updates from counsel, financial advisors and others, as to the shareholder activists and as to their legal and financial obligations in responding to shareholder activists and the current and evolving legal, financial and shareholder landscape for companies and shareholder activists.
- Clear corporate communications strategies should be established, coordinated and observed through a single executive or team when communicating with shareholder activists, shareholders and the market generally so that a consistent message is provided to the market. Inconsistencies should be avoided, since they could give the impression of corporate management confusion and corporate vulnerability.

Monitor Shareholders and Trading Patterns

1. Companies should consult with market watch services and proxy solicitation specialists to monitor the Company's shareholder base and any unusual trading changes or patterns. Companies should also monitor the shorter interest levels and positions in the market place, since increased short positions may well reflect the trading and derivative strategies of some hedge fund activists.
2. Companies should monitor Schedule 13D/G filings, Section 16(a) filings, insurance and mutual company filings, as well as Hart-Scott-Rodino, antitrust and other regulatory filings in order to identify important investors and their objectives and changes in ownership.
3. Companies should consult with securities analysts who follow their securities, since they are often the filter through which investors shape their views of the company and since they will often have good reads on investor views and concerns.
4. Companies should monitor changes in hedge fund and institutional shareholder holdings on a regular basis. Generally, they should understand the shareholder base, including, to the extent possible, relationships among holders.

Investor Relations

1. A company should review its dividend policy, analyst and investor presentations and other financial public relations.
2. A company should monitor analyst and media reports for opinions or facts about the company or the industry in which it operates that will attract the attention of attackers.
3. A company should proactively address reasons for any shortfall in company performance in comparison to competitors or street expectations.
4. Companies should maintain regular, close contact with major institutional investors. Companies should consider whether a proactive road-show for major institutional investors would be helpful or appropriate, while nonetheless being aware of selective disclosure, gun-jumping and other legal constraints as to such sessions.

Potential Legal Inquiries for Companies and Shareholder Activists

If a company is confronting a hedge fund or other shareholder activist group, or if such shareholder activists are considering a campaign, they will each need to consider a variety of issues relating to those activist shareholders:

1. Have the shareholder activists complied with their Schedule 13D/13G filing obligations, which is required when the activists or a group of which they are a member acquire more than 5% of the Company's publicly traded shares? Issues of group status and plans for the Company require careful consideration and disclosure in these filings.
2. Is the shareholder activist acquiring more than 10% of the company's shares? This raises Section 16(a) reporting issues and Section 16(b) profit disgorgement issues as to 6-month short-swing trades.
3. If the Company is in a regulated industry, such as banking, insurance or broadcasting, have the shareholder

activists considered limits on ownership before state or federal regulatory approvals are obtained?

4. Does the company have a poison pill or should and could one be adopted, or if a pill is in place, can the adverse person provision ownership threshold be reduced by the board?
5. Have the shareholder activists considered that many state corporate codes have business combination, control share acquisition, anti-greenmail and other provisions which result in negative consequences upon crossing specific ownership threshold, such as profit disgorgement, super-majority voting requirements or other hurdles for corporate transactions involving the large shareholder?
6. Is the shareholder activist in possession of material non-public information which might restrict their trading of company securities? If so, have they established sufficient Chinese walls to insulate that inside information and to continue trading without creating insider trading issues?
7. One of the most challenging issues for shareholder activists and companies is whether the conduct of shareholder activists provides the basis for viewing them as a "group" or otherwise acting in concert, which could be very problematic for them for a number of reasons. Group status is a largely "facts and circumstances" inquiry, which doesn't necessitate a formal group agreement to establish the presence of a group, and therefore provides some uncertainties. Group status could be relevant in view of:
   - 5% group filings and disclosures under Schedule 13D/13G filings;
   - HSR and antitrust group filings;
   - 10% shareholder group Section 16(a) filings and 10% shareholder Section 16(b) group short swing profit disgorgement liability;
   - Triggering adverse person provisions in poison pills;
   - The unavailability of group communications exemptions under the proxy rules (i.e., more than 10 deemed group member shareholders communicating about votes regarding fundamental company changes may violate the proxy rules); and
   - Group triggering shareholder thresholds under company charter and by-law provisions or business combination, control shares, anti-greenmail and similar provisions.

If you have any questions regarding these issues, we would be pleased to discuss them with you. For more information, please contact any of the attorneys listed below or any other member of our corporate and securities group. If you would prefer to receive distributions electronically and are not receiving them that way now, please send your e-mail address to mnoonan@mayerbrownrowe.com.

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