ICR

Corporate Governance White Paper

Shareholder Activism: Proactive Defense and Informed Response

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Activism

> Ensure that the company's investment bankers, lawyers and public relations consultants are at the ready with state-of-the art programs for responding to a potential attack.
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> *— Mergers attorney Martin Lipton's advice to clients regarding shareholder activism (NY Post, February 17, 2006)*

> The real problem in this country is that we don't have good management. We don't have accountability. There's no way to get rid of these managers. You all can do something about it," he said to the institutional investors in the audience. "Your fiduciary duty is to stop these managers and hold them accountable.
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> *— Carl Icahn billionaire investor said in his speech at the RiskMetrics Group's 2008 Governance Conference in New York February 5, 2008.*

Since the first company went public, investors have been utilizing creative and often confrontational strategies to engage with issuers to achieve their sometimes self-serving goals as well as positive returns from their investment portfolios. Such shareholder activism, traditionally the purview of institutional investors such as labor unions, public pension funds, and religious organizations, has become increasingly contentious and problematic for issuers as the rapidly growing hedge fund asset class has moved toward direct activism. Hedge funds are managed aggressively and are driven to extract as much value as possible from their investments. Currently, roughly 13,000 hedge funds wield more than $1.8 trillion in investable capital, an increase of over 400% since 2000. Some of the most aggressive asset managers have moved into this category because the hedge fund structure allows managers to charge premium fees for performance. Typical hedge funds charge a 1% (or higher) annual management fee. They also receive 20% (or more) of annual fund profits as a performance incentive fee. The most assertive of hedge funds are the "activist hedge funds" who work to derive value from their investments by taking a significant and active role in a company's decision process, often through acquiring board seats or more rarely board control.

While "activism" among shareholders is not new, the credit crunch of last summer has fueled hostility in the current activist environment as more hedge funds chase fewer investment opportunities and face a depressed capital market. This environment has created a scenario whereby activist investing increasingly becomes the norm as hedge funds try to differentiate themselves and continue to deliver the outsized returns that they have promised to their investors. As a result, public companies need to reconsider their preparedness and carefully address how best to protect their position in the public markets.

“Sharks,” “Wolves” and “Jaguars”

ICR has compiled a proprietary list of activists and have studied their styles, philosophies and tactics. Additional information is available upon request. Based upon our accumulated knowledge, we believe that some commonality exists and that most activists can be categorized based upon their level of activity, approach and tactics into the following categories:

Level I: “The Sharks”

These are the hedge funds or individuals that are primarily dedicated to activist investing. There are a number of funds within this category that have raised substantial capital in the last twelve months. They are the most frequent 13-D filers and often use the most aggressive tactics to pressure management teams and boards to effect organizational (operational, financial or structural) change.

Level II: “The Wolves”

These are the hedge funds or individuals that are frequent activists but typically choose to either follow others or act in concert with other investors. While they may not be the first 13-D filer, and generally are not always the most visible investor in an activist situation, they often will employ the same strategies as the “Sharks.” They choose to remain below the radar screen or to support the “Sharks’” activist initiatives especially in communications directed at the target company or in a proxy contest.

Level III: “The Jaguars”

These tend to be aggressive institutional investors that may never call themselves “activists” but nonetheless still sometimes take overt and aggressive positions relative to management or the board based upon their view of how to best maximize the value of their investment or to best achieve their other goals. Most of these funds tend to be large, based upon assets under management, and to not solely focus on activism. However, because of their size, they can oftentimes be very influential in persuading other shareholders to vote along with them.

How do Some Activists Describe Themselves?

Activists' own perception of themselves and their tactics may differ sharply from the perception held by the companies that they target. For purposes of illustration, below are two descriptions pulled directly from activist funds' websites to describe their theories on activist investing:

Shamrock Holdings

Shamrock's theory of activist investing relies on the ability of an influential shareholder to steer corporate decisions in a manner that will unlock shareholder value. Our activist investment philosophy is simple:

- A disciplined search for companies with deep value
- Buying influential equity stakes that permit responsible activism
- Using that position to promote strategic, structural, financial and operational improvements and to establish best governance practices

The Shamrock Team has extensive experience working in the "trenches" to assist Portfolio Companies in enhancing shareholder value through the companies' developing new business strategies, recapitalizing their balance sheets, instituting corporate restructurings, divesting subsidiaries or divisions, upgrading management teams and streamlining operations.

Relational Investors

PHILOSOPHY: "Management is Accountable to Shareholders"

Relational seeks to unlock underperforming companies' intrinsic value for their shareholders by improving management and strategic direction.

Relational believes that the best corporate governance structure fosters collaboration and allows shareholders to seek change through superior analysis and the methodical development of consensus for change. Relational believes that good stewardship requires intervention to address:

- Board composition
- Strategy (including M&A transactions and capital allocation discipline)
- Capital structure
- Corporate governance

STRATEGY & PROCESS: "Catalyst for Improved Performance; Active, Focused, Proprietary"

Relational's investment approach requires an intensely focused and planned process for investment choice and relational involvement.

- Relational maintains a limited portfolio of companies (from eight to twelve) with market capitalizations of at least $5 billion.
- Relational purchases a significant percentage of a company's outstanding shares, generally one to ten percent.
- Relational presents detailed recommendations for change to the company's management, board and, when necessary, shareholders. These changes are designed to stimulate a turn-around in the company's performance resulting in a re-rating of the company's shares in the public markets.
- Relational persists until the necessary change has been achieved, the company's securities have been re-rated by the market and are creating incremental shareholder value, or in some circumstances its valuation based on market conditions and company/industry dynamics is proven incorrect.

However, it's not just the activist funds that are developing aggressive "philosophies," it is also some of the largest public pension funds. The California Public Employees' Retirement System (CalPERS) has long been a leader in the corporate governance movement and is the largest public retirement system in the U.S. CalPERS' Board of Administration concluded that "good" corporate governance leads to improved long-term performance. CalPERS also strongly believes that "good" governance requires the attention and dedication not only of a company's officers and directors, but also its owners. Therefore, CalPERS is not your ordinary passive fund – they take seriously the responsibility that comes with company ownership and with $253 billion in assets, they are positioned as one largest and most active institutional activist shareholders. In fact, CalPERS recently made a $600 million commitment to Breeden Capital, an activist fund run by Richard Breeden, a former chairman of the SEC.

Goals of Activists

At the most basic level, shareholder and hedge fund activists want something from a company. Their desires can be for governance reforms, increased shareholder value or something more self-serving like a contract or control. Activists normally present themselves as working for the "greater good," with a tone that suggests moral superiority. While the goal of an activist fund may at times align with that of other investors, the indisputable reality is that each and every fund is singularly and exclusively concerned with whatever course of action will most benefit its own interests. Unfortunately, this goal often conflicts with the interests of other investors in the near-term and, most importantly, with what may be best for the company and its shareholders over the long term.

Moreover, in our opinion, hedge fund activists are typically focused on generating short term (less than one year) financial returns. This happens because the hedge fund business is judged (and compensated) based upon year-to-year performance and such funds must show consistently solid returns in order to sustain and grow their own investment base. These expected performance metrics have caused hedge funds to move toward event driven investing and activism which has shown to provide short-term shareholder value. The danger to companies and long-term shareholders is that a hedge fund's activism can disrupt management, destabilize the board, and could be at odds with the long-term goals of the company.

What makes a Company Vulnerable to Attack from Activists?

Activists generally have certain weaknesses that they screen for when searching for potential companies to target. These weaknesses include some of the following:

- Poor stock price performance relative to peers
- High cash balances
- Untapped or mismanaged opportunities for outsized returns
- Takeover defenses that entrench management and the board
- Poor corporate governance
- Perceived consolidation or buy-out opportunities

Institutional Investor Engagement

Institutional investors traditionally limit their "activism" to waging WITHHOLD campaigns, submitting shareholder proposals and supporting proxy contests and M&A transactions launched by more aggressive activists and hedge funds.

WITHHOLD or "No Vote" Campaigns

In 2007, the number of directors who received more than 15% WITHHOLD or AGAINST votes increased significantly to 543 at 250 S&P 1500 companies, according to Georgeson. This is 40% higher than in 2006, when 385 directors at 189 S&P 1500 companies received more than 15% WITHHOLD or AGAINST votes, and the highest such number since at least 2004.

Shareholder Proposals

Shareholder resolutions have always been proxies for shareholder dissatisfaction with how management or the board is conducting itself. The proponents of these proposals are most often labor unions, public pension funds, and religious organizations. Proposals targeting governance issues in particular are also often a strategy used by proponents to engage issuers in a dialogue – they are often not intended to be an end but instead a means to an end. In 2007, 665 shareholder proposals were submitted to S&P 1500 companies however only 375 came to a vote, according to Georgeson. The others were either omitted or withdrawn, presumably after the shareholders' concerns were satisfied.

Proxy Contests and M&A Transactions

The success of activists in reducing corporate defenses has paved the way for more proxy contests seeking representation on the board, or even control, of public companies. Not unexpectedly, the number of proxy fights initiated in 2007 increased dramatically. According to FactSet SharkWatch, 501 activist and other campaigns for corporate control were announced during 2007 year, an increase over 2006's 429 campaigns. The number that actually came to a vote in 2007 jumped almost 50% since 2006 (46 versus 31), according to Georgeson, representing an all time high since at least 1998.

In both 2006 and 2007 activists were successful in winning a significant percentage of board elections. But vote results tell only part of the story – settlements are commonly considered to be dissident "wins." This track record has led many target boards to be more willing to settle with the activists prior to a vote.

Hedge Fund Engagement

When a company meets a hedge fund activist's investment screening criteria, the activist will typically begin buying shares of that company. If an investor takes a position larger than 5% of a company's outstanding shares, that investor is required to file a 13-D with the Securities & Exchange Commission. A 13-D filing would name the reporting person(s) or group, how many shares they own and how much voting power they have. A 13-D will also describe the purpose of the investment – whether it be strictly for investment purposes, or for the purposes of a sale of the assets of the company, changes in the company's charter/by-laws, or any other plans or proposals relating to the company.

A 2006 study Hedge Fund Activism, Corporate Governance, and Firm Performance ("2006 Study") which analyzed hedge fund activism from 2001 through 2006, reveals that the motives behind hedge fund activism can be classified into five major categories:

- Maximize shareholder value
- Distribute excess cash, increase leverage, increase dividends or stock repurchase
- Refocus business strategy, including operational efficiency, cost cutting, excess diversification, and divest assets
- Sell the company
- Improve corporate governance

The 2006 Study also reveals the tactics that hedge funds utilize:

- Communicate with the board/management with the goal of enhancing shareholder value
- Seek board representation without a proxy contest or confrontation with the existing management/board
- Put forward shareholder proposals, or publicly criticize the company and demand change
- Threaten a proxy fight in order to gain board representation, or sue the company for breach of duty, etc.
- Improve corporate governance
- Launch a proxy contest in order to replace the board
- Sue the company with the intention to take control of the company, e.g. with a take-over bid.

At some point, the majority of hedge fund activists will employ a common and tremendously effective tactic – taking their case public. Some activists will do this immediately by simultaneously sending a letter to the Board and issuing it as a press release without having had any prior dialogue with management. Others will seek to make their case privately, likely knowing it will be to no avail, and then go public bolstering their view with the claim that they have "tried to have their concerns addressed amicably." In either case, activists have recognized the value of influencing public opinion and utilizing the threat of bad press and a public dispute as leverage in achieving their goals.

Teaming Up, Wolf Packing and Cascading In

The 2006 Study also reveals that in approximately 22.1% of hedge fund engagements, the Schedule 13D filing reported multiple unaffiliated hedge funds as having "teamed up." This does not include cases where multiple funds follow one another in investing in targeted companies, forming a so-called "wolf pack" that act together to force the target to address their demands, but do not require the filing of a Schedule 13D together because their actions do not rise to the level of "group" activity under securities laws. Nor does it include other hedge funds and more mainstream investors that "cascade" into the target firm's stock after the lead hedge fund's Schedule 13D filing to ride on the lead hedge fund's intervention effort. Compared to single-fund-filing cases, multiple-fund filing groups are more likely to employ hostile tactics (41.9% vs. 23.9%).

One result of this teaming up, wolf packing and cascading in is that a company's shareholder base can change dramatically from long-term holders to event-driven investors in a very short period of time. Dramatic shifts in shareholder composition can be extremely disruptive to companies, and can even completely undermine management and/or the board.

Proactive Defense Against Activism

The most important issue for directors is **"anticipating attacks by activist hedge funds seeking strategy changes by the Company to boost the price of the stock."** Martin Lipton Wachtell, Lipton, Rosen & Katz (2006)

There are a number of proven strategies to prevent engagement from an activist shareholder. For obvious strategic and proprietary reasons we have not included that information in this publicly-available document but we will provide it as appropriate following a request. The fundamental tenets of effective strategies include the following:

- Know your shareholders
- Be accessible and visible to the Street
- Set and communicate achievable goals
- Optimize your balance sheet
- Shore up any corporate governance weaknesses
- Effectively communicate your business strategy
- Advance notification by-laws
- Hire experienced professionals to advise management and the board.
- Ensure that the professionals retained do not also represent activists, in order to avoid receiving advice that is inherently conflicted
- Be ready to communicate with employees, the media, and the general public
- Don't underestimate the resources of the activist investor

Informed response to Activism

"At its core, shareholder activism is a communications battle to win the support of the shareholder base to support a particular direction for the company." Morgan Joseph Management in an Era of Shareholder Activism (2006)

Effective response to and mitigation of hostile activity is dependent upon thorough advanced preparation - preparation will enable a company to identify and address potential vulnerabilities before a threat emerges and to respond effectively to prevent the situation from escalating further.

First, companies should consider shoring up any corporate governance vulnerabilities.

One proactive measure that companies can take is an evaluation of their corporate governance structure and practices and then a shoring-up of any weaknesses. Most public companies have significant institutional ownership. Activists understand that in order to succeed in their goals they will need the support of institutional investors. Certain governance structures and practices are viewed as being unacceptable to institutions and proxy advisory firms. By adding governance changes to their list of demands against a company, an activist can benefit from winning the support of institutional holders and the proxy advisory firms.

According to RiskMetrics Group, the top ten governance proposals for 2007 (as of the second quarter of 2007) in order of prevalence were:

- Advisory Vote on Executive Pay (41)
- Independent Board Chair (40)
- Pay for Performance (38)
- Majority Vote in Director Elections (37)
- Board Declassification (34)
- Link Performance to Equity Awards (25)
- Cumulative Voting (22)
- Rescind Supermajority Vote Requirement (20)
- Redeem/Vote on Poison Pill (14)
- Golden Parachute Approval (11)

The top ten governance proposals for 2007 (as of the second quarter of 2007), according to RiskMetrics Group, in order of average support were:

- Rescind Supermajority Vote Requirement (67.8%)
- Board Declassification (63.9%)
- Golden Parachute Approval (52.5%)
- Majority Vote in Director Elections (50.3%)
- Advisory Vote on Executive Pay (41.7%)
- Redeem/Vote on Poison Pill (40.9%)
- Cumulative Voting (34.2%)
- Link Performance to Equity Awards (31.9%)
- Pay for Performance (29.8%)
- Claw-Back (28.9%)
- Independent Board Chair (24.8%)

Second, companies need to know their shareholders and to consistently reach out to their largest holders.

Long-term shareholders should be any company's best ally should an activist situation arise. Companies should consider hiring outside resources that can provide the board and senior management with "unfiltered" feedback on what shareholders think about the company. Understanding the mood of a company's shareholder base allows management to gauge investor confidence and should be part of every company's risk assessment.

Third, a company's senior executives and directors need to become knowledgeable about activists, their tactics, and their typical investment strategies.

Acknowledging that even rumors of potential activism can cause turnover in the shareholder base, companies need to consistently monitor their holders with an eye towards changes in trading volume, extraordinary stock purchase patterns, and conversions of convertible products. Anomalies can be the first indicator that a shareholder is altering their investment strategy in the company's stock with the intent to effect changes in their target investment.

Fourth, companies need to make sure that they are reaching out often and substantively to Wall Street.

We find that most senior management teams and boards have not kept up with the rapidly changing capital markets landscape and often appoint junior investor relations people to the task of being their "conduit" to the capital markets. Companies should consider hiring outside resources that know their industry/sector and can advise the board and senior management on how to best negotiate the Street.

Lastly, if an activist does show up, a company should meet with the dissident group to attempt to mitigate their concerns before they escalate to a proxy contest or other hostile public action.

When companies are contacted by activists, they should consider establishing a "fight team" composed of experienced investment bankers, attorneys, investor relations and crisis communications professionals with strong capital markets expertise and knowledge of the company's industry and activism to advise management and the board of directors. The company and its fight team should thoroughly evaluate the validity of the dissident's claims and determine whether or not the suggested changes are warranted through a frame of maximizing shareholder value.

The recent track record of activists forcing change at target companies through proxy contests (winning seats at more than 40% of larger cap targets) coupled with increased support from institutional investors have given activists significant negotiating power and has led many target boards to be more willing to settle with the activists prior to a vote. The 2006 Study reveals that target companies choose to accommodate hedge fund activists 29.7% of the time, to negotiate 29.1% of the time, to fight/resist 41.3% of the time.

Should the situation escalate to a proxy contest, the company and its fight team should thoroughly evaluate the dissident's platform and plans for change and the company's nominating committee should evaluate the qualifications of the dissident nominees. A thorough evaluation of the company's shareholder composition and vote projections should be undertaken. Institutional investor road shows should be prepared and scheduled. Fight letters and other media should be drawn up and released. Visits with proxy advisory firms should be planned and prepared for. Lastly, contact with retail and NOBO holders should be made.

Informed preparation by management teams and their advisors will significantly improve a company's ability to identify and properly handle activist investors. Through open communications with shareholders and Wall Street; minimizing governance risks; and understanding the activists' goals, tactics and strategies, a company can best position itself to prevent or defend against activism.

Biographies

Robin Mayns Cowles is co-head of ICR's Corporate Governance unit. Robin has diversified experience in the research and analysis of corporate governance practices, executive compensation, and equity plans first as the Director of Research at JMR Financial where she formulated proxy voting policies for institutional investors and assisted activist shareholders in drafting shareholder proposals. Then at Investor Responsibility Research Center (IRRC) where she concentrated on equity plan and M&A analysis. Robin was most recently with Institutional Shareholder Services (ISS) where she first sat on the US Research Helpdesk and was responsible for all internal and external communications with ISS' Research department and later as the Manager of Strategic Alliances where she was responsible for initiating and developing relationships with ISS' partner firms. Robin holds an MBA from The George Washington University and has an additional 20 years of experience in executive recruiting, management consulting, and small business management.

Brandon M. Meyer is co-head of ICR's Corporate Governance unit and has committed his career to Corporate Governance. Brandon joined ICR from Institutional Shareholder Services, the preeminent proxy advisory firm. During his time with ISS, Brandon gained experience as a research analyst, manager of the Global Corporate Governance Quotient (GCGQ) product, and as a Corporate Governance Advisor. He has worked on a variety of projects such as research policy formulation, product enhancement and strategy, as well as developing client relationships through his advisory work. Brandon graduated from Muhlenberg College with a Business Degree and a concentration in Entrepreneurship.

About ICR

ICR is a leading financial communications firm specializing in investor relations, corporate communications, digital media, and corporate governance. Established in 1998, ICR represents more than 240 publicly-listed companies and maintains offices in Westport, CT, New York, Los Angeles, Boston and Beijing. ICR is one of the industry's fastest growing consultancies, and is consistently listed among the nation's top independent communications consulting firms. www.icrinc.com.

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