

Shareholder Activism and the Use of Litigation to Accomplish Investment Goals

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The explosion in innovative activism strategies has resulted in a parallel burst in activist shareholder litigation. Increasingly, lawyers are called upon not only to shepherd the activist process – disclosures, proxy filings and the like – but also to scope out novel tactics to address issues which straddle the legal and investing landscapes. These tactics could include a modification to a company's capital structure, a proposed merger or spin-off or the implementation of corporate governance measures designed to protect shareholder interests.

This evolution, while not revolutionary, is occurring at a fast pace. Five years ago, our firm, working in conjunction with plaintiffs the Florida State Board of Administration and the Teachers' Retirement System of Louisiana, managed to sweeten the \$162m recovery in *In re Dollar General Corp. Securities Litigation*, No. 3:01-0388 (U.S. Dist. Ct., M.D. Tenn.), with what were then novel and state-of-the-art corporate governance remedies.

Such remedies included requiring the company's directors to stand for election every year with at least two-thirds of the directors being independent; requiring the independent directors to meet at least once a year without the company's chief executive officer or other non-independent directors; and ensuring that the company maintained intensive internal audit and insider trading policies. What was then state-of-the-art is now accepted as common.

In fact, it has become customary for governance fixes to focus on structural issues, such as board independence, internal controls or executive compensation. While still relevant and necessary, those issues are now standard. What has changed? Today, the focus is on transactions and, increasingly, on corporate capital structure.

Transactions, of course, come in a variety of sizes and shapes, but recent activist engagements can be separated into two broad categories. First, there are those transactions proposed by companies and opposed by owners. In such cases, activists' goals are generally to change or kill the transaction.

Consider how investors, led by Elliott Associates, effec-

tively forced MCI to auction the company, with competing bids from Verizon and Qwest, long after the board of MCI had accepted a lower Verizon bid. You may also recall how TCI and Atticus not only killed Deutsche Borse's bid for the London Stock Exchange, but also cost Deutsche Borse's CEO his job in the process.

The second category is, effectively, the opposite of those proposed by companies: activist investors suggesting transactions in the face of corporate inertia. While just a few large battles of this kind have garnered huge headlines – such as Carl Icahn's tilt at Time Warner – the fact is that scores of such scenarios have happened over the past few months, with activists often getting most, if not all, they desire.

For example, consider what's been developing at Wendy's for the past eight months. Activist hedge fund Pershing Square purchased 9% of its stock. Pershing then recommended that Wendy's spin off its successful Tim Horton's chain, re-franchise some of its restaurants and use the proceeds to fund a stock buy-back. Ultimately, Wendy's agreed; the stock rose 13.1% that day, and has continued to rise, up more than 33% in the eight months since the announcement.

The fact that Pershing Square suggested a buy-back is not an accident. In fact, the focus on corporate capital structures and balance sheets is a consistent theme across many recent situations. Most recently, Paulson & Co. argued before the Ontario Superior Court in Sault Ste. Marie, Canada that Algoma, a Canadian steel company, was hoarding cash. Paulson pressed its case in a number of ways, including a formal demand for an extraordinary meeting of shareholders, a demand upheld by the court. Two weeks before that meeting was to take place, Algoma agreed to return C\$200m to shareholders in exchange for Paulson's withdrawal of its request for the extraordinary meeting. Algoma further agreed to elect two new directors agreeable to Paulson. In fact, Algoma is only the latest company to agree to consult with an engaged owner with regard to new directors; others include Dynegy, Ashland, HealthSouth and Hanover Compressor.

The new focus on transactions and on corporate capi-

tal structure has forced shareholders' lawyers to bridge various disciplines. Being a good lawyer now means being competent at corporate finance, public relations, investor relations and even asset management. It also means being able to master complex litigations crossing practice areas and jurisdictions, as evidenced by the battle between Relational Investors and Sovereign Bancorp. In that case, Relational had sought to elect a number of directors to Sovereign's board, a tactic it has used well – and won plaudits for – in companies as varied as Waste Management, Mattel and Apria Healthcare.

In the past, companies had either agreed to nominate a director suggested by Relational, or waged a proxy battle. Sovereign, however, invented a new defense strategy. First, it parked a huge block of votes in friendly hands, selling 19.8% of the company, as well as an option for an additional stake of approximately 5%, to Santander, a Spanish bank. Then, it lobbied for, and won, a change in the Pennsylvania law to make it harder to remove directors.

Without getting into the merits of each side's legal and financial case, consider the arguments and venues Relational has had to use simply to make its legal case. First, Relational challenged the Santander sale at the New York Stock Exchange, stating that the sale to Santander constituted a change in control, as defined in the listing standards and, therefore, required shareholder approval. Relational then made relevant filings under Pennsylvania corporate law and Federal securities law. Finally, Relational brought suit in Federal court to argue that the amendment to the Pennsylvania corporate law would be a retroactive change in the law, and should not govern in this case. That approach is a far cry from simply filing a proxy resolution.

Legal creativity today is virtually mandatory, even when the legal action is designed to bring about a traditional corporate governance goal. The coalition of investors challenging News Corp.'s decision to institute a poison pill without shareholder approval seeks a traditional remedy – the company should either redeem the pill or put it to owners for a vote. To reach that goal, however, the coalition has put forth the novel legal argument that News Corp.'s public statements last year promising not to institute a pill without owner approval in return for a shareholder vote allowing reincorporation from Australia to Delaware, effectively constitutes a contract. Further, the coalition argues that such a contract with shareholders trumps the normal discretion of directors, since direc-

tors derive their power from those same holders. The company claimed, as companies have for a generation, the right to put in a pill under the ordinary business judgment rule. Thus far, however, the investors have had the best of it. While the ultimate court ruling is uncertain, the court has agreed, at least initially, with the contract theory and has allowed the case to proceed.

Still, all this creativity and transactional practice comes atop, not in place, of the most common situation: a combination of governance remedies with monetary settlements in asserted fraud actions. For example, in the recent case *In re Royal Ahold, N.V. Securities Litigation*, 1:03-md-1539 (U.S. Dist. Ct., D. Md.), in which we serve as Lead Counsel, the company agreed to a \$1.1bn settlement. In the wake of that litigation and the parallel SEC proceedings, the Company also agreed to several corporate governance reforms, including: (1) the installation of an advisory board designated with the responsibility of supervising required changes in control systems and ensuring the implementation of more stringent corporate governance principles throughout the entire company; (2) the implementation of uniform whistle-blower procedures that apply to the company's US and European operations; and (3) the establishment of a new office of governance, ethics and compliance, reporting directly to Ahold's Chief Corporate Governance Counsel and the CEO of the Ahold subsidiary that was involved in the alleged fraud. Finally, the fired, former CEO and CFO of the company agreed to return part of their previously paid bonuses.

Lawyers have always prided themselves on being able to provide legal expertise and creative tools to their clients. Today, that is surely not enough. In an investment landscape increasingly sculpted by activist investors focused on transactions and capital structure, lawyers need specialized legal skills as well as advanced finance and market knowledge in order to properly advise their shareholder clients, particularly through complex and sophisticated investment-related matters.

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