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Activist Hedge Funds Find Myriad Ways to Profit from M&A Transactions

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Activist hedge funds continue to find ways to use public M&A transactions as a tool to generate returns for their investors. As a result, market participants need to consider potential activist strategies in determining how to structure, announce and execute their deals.

Activists have used three principal strategies to extract additional value from public M&A transactions. The first strategy involves directly challenging the announced deal in an effort to extract a higher price, defeat the merger and/or pursue an alternative transaction or stand-alone strategy. The second strategy involves attempting to use statutory appraisal rights to create value for the activist. And the third strategy involves making an unsolicited offer to acquire a target, either independently or in conjunction with a strategic acquirer, to put the target in play. In this article, we discuss examples of recent uses of these strategies by activist investors and point out some general implications of these examples for transaction planners.

STRATEGY ONE: CHALLENGING AN ANNOUNCED DEAL

One strategy that has been employed by activist hedge funds has been to acquire stock in a public merger target shortly after the transaction has been announced, announce opposition to the transaction and seek to encourage other stockholders to also oppose the transaction, support an alternative transaction proposed by the activist or pressure the acquirer to restructure the transaction and/or offer additional consideration to the stockholders of the target.

Two examples of public transactions in which activist opposition resulted in a change of deal terms are described below:

- **Dell/Carl Icahn.** The most highly publicized recent use of this strategy was Carl Icahn's opposition to the buyout (the "**Dell Transaction**") of public stockholders of Dell, Inc. ("**Dell**") by Dell founder, CEO and 16% stockholder Michael Dell and private equity sponsor Silver Lake Partners (the "**Silver Lake Group**"). Shortly after the Dell Transaction was announced in February 2013, funds affiliated with Icahn announced that they had accumulated a substantial stake in Dell. Icahn and his affiliates joined together with institutional stockholder Southeastern Asset Management and waged a fight to defeat the transaction, in which Icahn engaged in a campaign of letters, press releases, interviews and social media posts attacking the announced transaction.

Icahn filed proxy solicitations opposing the transaction, nominated a slate of directors to replace Dell's Board and proposed no fewer than three alternative transactions. Notably, Icahn attacked both Michael Dell and the Board of Directors of Dell as part of his campaign. Icahn argued that Michael Dell was hurting Dell and showed little

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regard for the interests of Dell's other stockholders, pointing to the decline in Dell's stock price since Michael Dell was reappointed CEO in 2007.¹ Icahn and Southeastern also accused the Board of Directors of Dell of painting a dark picture of Dell's prospects to "frighten stockholders into selling Dell to Michael Dell and Silver Lake" and threatened "years of litigation" against directors for breaches of fiduciary duty in connection with the transaction.²

The Dell Transaction was ultimately approved by the stockholders of Dell and was consummated in October 2013 after the Silver Lake Group agreed to increase the consideration payable to stockholders not affiliated with the Silver Lake Group by \$350 million.³

- **MetroPCS Communication/John Paulson/Peter Schoenfeld.** Another example of this strategy was John Paulson's and Peter Schoenfeld's campaign against T-Mobile USA's ("**T-Mobile**") acquisition of MetroPCS Communication ("**MetroPCS**") in a stock-for-stock merger (the "**MetroPCS Transaction**"). Paulson & Co., Inc. ("**Paulson**"), one of MetroPCS's largest stockholders, increased its stake in MetroPCS to 9.9% after the announcement of the transaction in late 2012.⁴ Together with P. Schoenfeld Asset Management ("**PSAM**"), which owned approximately 2% of the stock in MetroPCS, Paulson publicly opposed the MetroPCS Transaction.

Paulson and PSAM released a series of letters to public stockholders of MetroPCS and the Board of Directors of MetroPCS criticizing the amount of financial leverage that the combined company would bear through \$15 billion in senior debt that would be owed to T-Mobile's parent company, Deutsche Telekom AG, and arguing that this debt would put the combined company at a disadvantage when competing against industry peers.⁵ In addition, PSAM released a white paper criticizing the MetroPCS Transaction terms as "grossly unfair to the [MetroPCS] shareholders" and "unfairly favoring Deutsche Telekom" in its capacity as senior creditor and controlling stockholder of the combined entity, which PSAM called a "serious conflict of interest" and violation of "good corporate governance" norms.⁶ PSAM filed a proxy statement soliciting the proxies of MetroPCS stockholders to vote against the transaction and proposed that MetroPCS remain a stand-alone company.

After proxy advisory firms Institutional Shareholder Services and Glass Lewis & Co. recommended that stockholders of MetroPCS vote against the deal, MetroPCS and Deutsche Telekom agreed to revise the terms of the transaction to reduce the principal amount of debt to be issued by the combined company to Deutsche Telekom at closing by \$3.8 billion, reduce the interest rate on this debt by 50 basis points and make certain other changes to the terms of the transaction. In response to these changes, Paulson and PSAM dropped their opposition and the MetroPCS Transaction was consummated in May 2013.

¹See Schedule 13D, filed by Icahn Capital LP with the SEC, July 31, 2013.

²Schedule 13D, filed by Icahn Capital LP with the SEC, July 8, 2013; Arik Hesseldahl, "Icahn Threatens Dell With 'Years of Litigation' Over Buyout," AllThingsD.com, Mar. 7, 2013.

³It was reported that Icahn earned a profit of \$70 million from his efforts to oppose the Dell transaction based on the appreciation of the Dell stock between the time of his purchases and the consideration ultimately offered by the Silver Lake Group. David Benoit, "Carl Icahn Looking at \$70 Million Profit on Dell Investment," WSJ.com MoneyBeat, Sept. 9, 2013.

⁴Schedule 13D, filed by Paulson & Co., Inc. with the SEC, Feb. 28, 2013.

⁵Schedule 13D, filed by Paulson & Co., Inc. with the SEC, Mar. 27, 2013.

⁶P. Schoenfeld Asset Management, Analysis of Proposed Combination with T-Mobile USA, Inc. & Standalone Alternative, Mar. 18, 2013.

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The following examples show the variety of tactics that have been used by activists to oppose an announced transaction:

- **Publicly Criticizing the Transaction.** Activists will make arguments against the transaction publicly, repeatedly and in manners calculated to generate widespread attention. Icahn, Paulson and PSAM made public arguments against the relevant transactions by sending letters to the Board of Directors and stockholders of the target, issuing press releases and using websites and social media services like Twitter to oppose the announced transaction and argue that the announced transaction was unfair to the stockholders of the target.
- **Soliciting Proxies Opposing the Transaction.** Activists may seek to solicit proxies from other investors to block the transaction or put pressure on the target's Board. Icahn and PSAM each filed proxy statements with the SEC seeking to solicit proxies to vote against the transaction. Icahn also nominated slates of directors to replace the directors who supported the transaction.
- **Lobbying Institutional Stockholders and Proxy Advisors.** Activists will often lobby large institutional stockholders of the target and proxy advisory firms like Institutional Shareholder Services to oppose the transaction. In the MetroPCS Transaction, the opposition of proxy advisory firms appeared to tip stockholder opinion against the transaction and force the transaction participants to modify the terms of the deal.⁷
- **Proposing Alternative Transaction(s).** Activists may propose alternative transactions, such as recapitalization transactions or an alternative acquisition by the activist and its allies. Icahn and his allies proposed both of these alternative transactions, as well as a self-tender offer by Dell, in their campaign of opposition to the Dell Transaction.
- **Attacking the Acquirer and the Target's Board and Management.** Activists may accuse the acquirer and the target's Board of Directors and management team of self-dealing, fecklessness and/or incompetency in connection with the transaction and, in the case of the target's Board of Directors and the management team, the management of the target more generally.⁸

From an organizer's perspective, attacks by activist investors like Icahn and Paulson increase the risk that transactions will not be completed or that the transaction will need to be restructured. Attacks by activists can also be embarrassing to managers and directors and make them "gun-shy" about transactions. Further, even if the transaction is approved as announced, transaction participants face additional fees to legal and financial advisors and time and costs relating to responding to activist attacks and lobbying stockholders and proxy advisory services to support the transaction. These costs can detract from the resources that transaction participants can devote to closing the transaction and addressing post-closing matters.

⁷Scott Moritz, Cornelius Rahn and Aaron Kirchfeld, "MetroPCS's Largest Shareholder Paulson Backs Sweetened Bid," Bloomberg.com, Apr. 11, 2013.

⁸Icahn even tweeted the following couplet attacking Dell's Board of Directors and Michael Dell: "All would be swell at Dell if Michael and the Board bid farewell." Arik Hesseldahl, "Carl Icahn Blasts Michael Dell's Latest Buyout Offer with Twitter Poetry," AllThingsD.com, July 24, 2013.

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STRATEGY TWO: OBTAIN APPRAISAL OF SHARES IN TARGET

A second strategy used by activist investors to extract value from public M&A transactions is to acquire shares in a public merger target with the intent to exercise statutory appraisal rights after the transaction closes.

Statutory appraisal rights are the rights of a dissenting stockholder to seek “fair value” for its stock in a merger target in lieu of accepting the price offered to stockholders of the target under a merger agreement.⁹ Generally speaking, the dissenting stockholder must typically vote against the merger or abstain from voting, and then initiate litigation in which the stockholder asks a court to determine the value of the stockholder’s stock. However, the stockholder may purchase the stock of the target and perfect its claim for appraisal at any time prior to the date of the relevant stockholder meeting as long as certain technical requirements are met, allowing investors to “buy into” an appraisal claim after the transaction has been announced.¹⁰

Broadly speaking, analysts have noted an increase in the number of appraisal actions in connection with public merger transactions. Appraisal claims having a value of \$1.5 billion were brought in 2013, a 10-fold increase from 2004.¹¹ Further, 23 appraisal claims were filed in Delaware in 2013, and, as of mid-March, 20 have already been filed in 2014.¹²

Driving this increase in appraisal claims are potential returns to dissenting stockholders. In Delaware, the court in an appraisal proceeding must determine the value of the company on a going concern basis as of the date of the merger vote. Historical analyses of decisions by Delaware courts have found that appraisal litigation often results in courts awarding dissenting stockholders a fair value for stock in excess of the merger price paid.¹³ In addition, Delaware statutes entitle the dissenting stockholder to statutory interest on the fair value of the stock equal to the Federal Reserve discount rate plus 5% and compounded quarterly, a rate that may be attractive to investors in the current low interest rate environment.

Below are some examples of the use of appraisal rights by hedge funds in connection with recent transactions:

- **Dole Food Co./Merion Investment Management.** One recent, publicized instance in which an activist hedge fund sought appraisal rights in lieu of accepting the merger consideration was the 2013 buyout of Dole Food Co. (“**Dole**”) by its CEO David Murdock (the “**Dole Transaction**”). In the Dole Transaction, Murdock purchased the 61.3% of the stock in Dole he did not own for \$13.50 per share, an amount below the price that analysts ascribed to the company’s stock.¹⁴ Only 50.9% of the company’s public

⁹In Delaware, courts have considerable discretion in the analysis that they use to determine the fair value of shares, and stockholders typically introduce evidence of comparable transactions and the discounted cash flow value of the merger target to persuade the court to adopt a particular valuation.

¹⁰See *In re Appraisal of Transkaryotic Therapies, Inc.*, No. Civ. A. 1554-CC, 2007 WL 1378345, at *1 (Del. Ch. May 2, 2007).

¹¹Steven M. Davidoff, “New Form of Shareholder Activism Gains Momentum,” NYTimes.com Dealbook, Mar. 5, 2014 (citing an unpublished paper by Professor Minor Myers and Professor Charles Korsmo).

¹²David Katz and Laura McIntosh, “Corporate Governance Update: Shareholder Activism in the M&A Context,” *New York Law Journal*, Mar. 27, 2014.

¹³See Liz Hoffman, “Dell Shareholders Like Their Appraisal Odds in \$25B Buyout,” Law360, Sept. 10, 2013.

¹⁴See *id.*

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stockholders voted in favor of the merger.¹⁵ A few days before the merger vote on the Dole Transaction, hedge fund Merion Investment Management LP (“**Merion**”) announced its ownership of 8.3% of the outstanding stock of Dole. Merion and other investors, which collectively owned 14 million shares of Dole, exercised their appraisal rights and sought valuation of their shares by Delaware courts in lieu of the \$13.50 per share merger price.¹⁶

- **Dell/Carl Icahn.** In the Dell Transaction, Carl Icahn gave notice that he would seek appraisal of his stock in Dell. Icahn also issued press statements urging other stockholders to seek appraisal. Icahn ultimately decided not to seek appraisal for his stock in Dell; however, more than 100 other investors representing 47.5 million shares of Dell are reportedly seeking appraisal of their shares in lieu of accepting the \$13.75 per share consideration ultimately offered to stockholders.¹⁷ Among the major investors seeking appraisal for their shares are T. Rowe Price Group Inc., as well as hedge funds Magnetar Capital and Loeb King Capital Management.

Appraisal demands can represent a significant challenge for transaction participants. A determination by a court that the fair value of stock exceeds the merger consideration and the high statutory interest will increase the total amount of consideration payable by the acquirer to target stockholders. Uncertainty as to the amount of consideration payable can complicate an acquirer’s efforts to arrange financing for the acquisition. In addition, appraisal demands also impose costs on the acquirer in time and legal fees relating to the litigation.

STRATEGY THREE: INITIATE TRANSACTIONS THROUGH UNSOLICITED OFFERS

A third strategy that activist hedge funds have used is making unsolicited acquisition proposals themselves for publicly traded companies in order to put the companies into play.

Historically, it was perceived that activist hedge funds were generally uninterested in actually taking over a public company. Rather, the activist’s intention was to make an offer to purchase the target to put the target “in play” and then sell into an offer made by a strategic acquirer paying a higher price than the price offered by the activist. Such bids would fail if the intentions of the activist were transparent and the activist failed to convince the target or its stockholders to take its bid seriously.

An example of this approach was Carl Icahn’s 2011 offer to acquire Clorox. Icahn purchased approximately 9.37% of the shares in Clorox during late 2010 and 2011.¹⁸ Icahn then made an offer to acquire the remaining shares of the company for \$10.2 billion; however, the offer was subject to significant conditionality. At the same time, Icahn sent a letter to the CEO of Clorox “strongly suggesting” that Clorox “aggressively pursue a transaction with a strategic buyer, which should attract a higher price” because of the possible synergies with a strategic acquirer.¹⁹ Clorox rejected Icahn’s offer as “inadequate and ... unlikely to be completed.” Icahn raised his offer to

¹⁵It is possible that certain investors could have “split their shares,” voting some shares in favor of the merger to ensure that the merger was approved, while withholding their vote of other shares in order to seek appraisal.

¹⁶Steven M. Davidoff, “New Form of Shareholder Activism Gains Momentum,” NYTimes.com Dealbook, Mar. 5, 2014.

¹⁷Michael Weiss, “Dell Appraisals Demanded by T. Rowe to Magnetar Capital,” Bloomberg.com, Nov. 28, 2013.

¹⁸Schedule 13D/A, filed by Icahn Capital LP with the SEC, Aug. 18, 2011.

¹⁹Chris V. Nicholson, “Icahn Bids for Clorox, but Urges It to Seek Higher Offers,” NYTimes.com Dealbook, July 15, 2011.

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\$10.7 billion but ultimately withdrew his offer and his efforts to initiate a sale, acknowledging that he could not persuade major Clorox stockholders to support his plan.²⁰

Icahn is notable for having put a number of companies in which he owned shares into play by announcing unsolicited offers. A 2011 analysis indicated that Icahn had made 15 prior unsolicited offers to buy companies during the period between 1996 and July 2011 and that none of these offers had resulted in an acquisition by Icahn.²¹

On the other hand, a newer, more credible model of activist hedge fund-driven unsolicited offers may be emerging in connection with the proposed acquisition of pharmaceutical manufacturer Allergan, Inc. by activist investor William Ackman's Pershing Square Capital Management and acquisitive pharmaceutical company Valeant Pharmaceuticals International, Inc.

Pershing Square Capital and Valeant announced in April 2014 that they had created a jointly funded joint venture entity to acquire Allergan and that the joint venture entity had purchased stock, options and forward contracts giving it (and Pershing Square Capital and Valeant) beneficial ownership of 9.7% of the outstanding shares of Allergan.²² Then, in late April, Valeant publicly presented an offer to acquire Allergan for \$45.7 billion in cash and Valeant stock in a merger that was not subject to a financing condition, stating that it was making the offer publicly after Allergan had rejected Valeant's private efforts to initiate negotiations for 18 months.²³

Allergan adopted a stockholder rights plan at the time Pershing Square Capital and Valeant's proposal was disclosed and formally rejected Pershing Square Capital and Valeant's proposal in mid-May without engaging in formal discussions.^{24,25} The co-bidders have indicated that they would raise their offer to show their commitment to completing a transaction. They have also stated that they would seek to replace some or all of Allergan's directors.²⁶

Although the outcome of Pershing Square Capital and Valeant's joint bid for Allergan remains in doubt, it is becoming clear that, together, an activist hedge fund like Pershing Square Capital and a strategic acquirer like Valeant have certain advantages that each lack if pursuing an unsolicited bid on its own:

- **Ability to Quickly Build an Initial Stake.** An activist hedge fund like Pershing Square Capital is able to build a position in the target company quickly before being required to disclose its position publicly and can use a variety of derivatives and other financial instruments to amass the position with a minimal initial outlay of capital. Because the core business of hedge funds is trading in securities, a hedge fund

²⁰Paul Ziobro, "Icahn Drops Bid to Control Clorox," *Wall Street Journal*, Sept. 24, 2011.

²¹Ellen Byron, "Will Buyers For Clorox Show Up?," *WSJ.com Deal Journal*, July 15, 2011.

²²Schedule 13D, filed by PS Management GP, LLC with the SEC, Apr. 21, 2014.

²³Letter from J. Michael Pearson to David Pryor, dated Apr. 22, 2014, filed with the SEC under Rule 425 under the Securities Act of 1933; Drew Armstrong and Beth Jinks, "Valeant Offers to Buy Allergan with Pershing's Support," *Bloomberg.com*, Apr. 22, 2014.

²⁴Form 8-K, filed by Allergan, Inc. with the SEC, Apr. 22, 2014.

²⁵Form 8-K, filed by Allergan, Inc. with the SEC, May 12, 2014.

²⁶Investor Presentation, filed by Valeant Pharmaceuticals International, Inc. with the SEC, May 8, 2014.

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does not face the same financial and reputational costs in selling this “toehold” as a strategic acquirer would face if the bid fails.²⁷

- **Higher Bids.** Synergies between a strategic acquirer’s business and the target’s business can allow the bidders to offer a higher valuation of the target and higher bids than an activist hedge fund could offer alone. Indeed, Pershing Square Capital and Valeant have touted the synergies between Allergan’s and Valeant’s respective businesses as reasons to support their joint bid for Allergan.
- **Public Relations.** Activist hedge funds are well versed in techniques such as investor presentations, letters to management and threats of a proxy contest that can be used to pressure a reluctant target into accepting an unsolicited offer, while strategic acquirers may be less adept with these tools.
- **Credibility.** The involvement of a strategic acquirer may make the offer more credible to target stockholders and to potential financing sources than an offer from the activist hedge fund alone.

The advantages that an activist/strategic joint bid brings to an unsolicited acquisition proposal are also relevant to participants in an announced transaction, who may face increased risk of “deal jumping” by activist/strategic teams of rival bidders. In particular, the speed with which an activist hedge fund can build a stake in a target means that the team can quickly acquire a toehold position from which the joint bidders can make a topping bid. At the same time, the presence of a strategic acquirer and the potential synergies with the target can increase the potential consideration that can be offered to public stockholders of the target. Higher deal prices make it easier for potential topping bidders to argue that the topping bid is a superior proposal to the existing transaction and that the target’s Board of Directors is compelled by its fiduciary duties to terminate the existing transaction and accept the topping bid.

Nevertheless, it is unclear how many activist/strategic joint bids will be seen in the future. Arrangements such as those between Pershing Square Capital and Valeant are complex and potentially difficult to negotiate, and financing obtained from hedge funds would likely be more costly to strategic acquirers than financing obtained from conventional sources. In addition, some strategic acquirers may worry about reputational consequences stemming from association with activist hedge funds and may be reticent to allow an aggressive activist the benefit of information and access that would be required.

CONCLUSION

The following are some general lessons that transaction participants can take from the trends and examples discussed above:

- **Be Prepared for Activism and Appraisal Demands.** Participants in high-profile transactions should assume that the transaction will draw meaningful interest from activist investors, although this interest may fall short of a full-fledged attack. Following the announcement of the transaction, the acquirer and the target should be prepared to work with their legal and financial advisors to monitor the market,

²⁷Trevor Norwitz, “A New Takeover Threat: Symbiotic Activism,” The Harvard Law School Forum on Corporate Governance, Apr. 25, 2014.

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respond to activist statements quickly and make the case for the business logic and fairness of the proposed transaction to the institutional investors, the proxy advisory services and the broader market.

Similarly, transaction participants should assume that there may be some number of demands for appraisal by stockholders. Accordingly, transaction participants should seek to account for appraisal demands in the pricing and terms of the transaction and allocation of legal resources for transaction-related litigation.

- **Monitor Strategic Acquirer Who May Team with Activists.** Participants in transactions should also consider whether there are any potential strategic acquirers who might team with an activist hedge fund to make a topping bid and monitor the actions of these potential acquirers. Particular attention should be paid to any potential strategic acquirer who has expressed sustained interest in engaging in a transaction with the target in the past.
- **Structure the Transaction Carefully to Minimize the Leverage of Activist Investors.** Participants in transactions should note that certain transaction structures may increase the leverage of activist investors.

For example, the merger agreement between Dell and the Silver Lake Group made the transaction subject to the condition that holders of a majority of the outstanding shares of Dell not affiliated with the Silver Lake Group vote to approve the merger.²⁸ The majority-of-the-minority voting condition gave leverage to Icahn and Southeastern, who collectively owned 12.8% of Dell's common stock, and could thus vote a disproportionately large portion of the unaffiliated stock of Dell against the Dell Transaction.

Transaction participants should weigh the utility of such structures against the risk that such structures may empower activists who are seeking to extract value from the transaction or force its abandonment.

- **Be Sensitive to Charges of Self-Dealing.** Activist attacks and demands for appraisal rights may be particularly frequent and acute in take-private transactions such as the Dell Transaction and the Dole Transaction. Participants in such transactions should anticipate accusations of self-dealing by activists when pricing and structuring the transaction.

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²⁸Such voting (or minimum tender) conditions are typically used as a protection when a controlling stockholder seeks to buy out minority stockholders to give the minority stockholders an opportunity to reject the transaction.