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Hushmail: Are Activist Hedge Funds Breaking Bad?

Increasingly, some activist hedge funds are looking to sell their stock positions back to target companies. How should the board respond to hushmail?

The Rise and Fall of Greenmail

During the heyday of takeovers in the 1980s, so-called corporate raiders would often amass a sizable stock position in a target company, and then threaten or commence a hostile offer for the company. In some cases, the bidder would then approach the target and offer to drop the hostile bid if the target bought back its stock at a significant premium to current market prices. Since target companies had fewer available takeover defenses at that time to fend off opportunistic hostile offers and other abusive takeover transactions, the company might agree to repurchase the shares in order to entice the bidder to withdraw. This practice was referred to as "greenmail," and some corporate raiders found greenmail easier, and more profitable, than the hostile takeover itself.

Some of the boards of directors of the target companies that paid greenmailers were sued by their stockholders, who alleged that the payments were made for the purpose of management entrenchment, the boards impermissibly favored the greenmailers over other stockholders and the price paid was excessive. However, Delaware courts generally upheld the board's decision to pay greenmail, on the grounds that it was a reasonable response by the board to the threat of an abusive or coercive hostile takeover.

Nevertheless, there was widespread outcry about the practice from target companies, institutional investors and the investing public. Federal and state laws were enacted in an effort to prohibit or restrict the payment of greenmail.[1] Also, companies developed more effective takeover defenses, making greenmail unnecessary as a defense. By the end of the 1980s, greenmailing was relegated to the sidelines of takeover history.

Hushmail in the Age of Activist Investing

Although greenmail has largely disappeared in the hostile takeover arena, the recent explosion of activist investing by hedge funds has brought about a related phenomenon, which can be referred to as "hushmail." Texas businessman H. Ross Perot coined the term in 1986, using it to describe an offer made to him by General Motors to buy out his GM stock at a premium price, in exchange for his agreement to stop publicly criticizing GM's management.

Activist hedge funds often start their campaigns against public company targets by taking large stock positions and then publicly agitating for changes, such as stock repurchases, extraordinary dividends, dispositions of non-core businesses or an outright sale of the company. There is often an implicit or explicit threat of a proxy contest to remove some or all of the target board members and management if their demands are not met. Ultimately, the activist may receive one or more seats on the target company board, either through a settlement with the target, or success at a stockholder meeting.

After a period of time pressing its case, the activist may desire to exit the investment. However, if it were to dump its shares in the market in large volume, the stock price realized in the sale may suffer. The situation becomes trickier for activists that have obtained board representation, because insider trading policies and SEC rules may significantly restrict their ability to dispose of shares quickly.

In order to exit quickly at the highest possible price, the activist sometimes seeks to have the target company buy back its stock. The buyback price is typically at a slight discount to the current market price, but occasionally it is at a premium. As part of the purchase agreement, the activist may enter into a standstill and non-disparagement agreement with the target. If the activist has representatives on the board of the target, the representatives typically would resign their director positions after the repurchase, given the activist's lack of ongoing economic interest.

In the last year, there have been numerous examples of companies buying back stock from activist investors.[2] For example, in April 2014, activist investor KSA Capital sold a 9 percent block of shares back to AEP Industries at a 4.5 percent premium to the current market price. After the buyback, KSA still owned 21 percent of the outstanding stock. As part of the deal, KSA signed a two-year standstill and non-disparagement agreement with AEP, and agreed to vote its remaining block in favor of director nominees nominated by the AEP board at the next two annual meetings of stockholders.

Breaking Bad?

In the modern era, activist hedge funds often proclaim that they are working to enhance value for all stockholders, and deny that they are seeking only personal financial gain. Activist investors have worked hard in recent years to improve their image with institutional investors, the investing public and companies.

In demanding a stock buyback, are activists breaking bad? Not unlike Walter White, who made the journey from devoted family man to antihero, an activist investor who seeks a hushmail buyout can fairly be said to be putting the activist's short-term interest in liquidity ahead of the interests of other stockholders, who are not offered the same deal. If activists increasingly seek hushmail buybacks, especially at premium prices, they run the risk of creating a broader market backlash, such as what occurred with the demonization of greenmailers in the 1980s.

Notwithstanding the reputational risks to activists, hushmail demands seem to be on the rise. Public companies need to be prepared to consider whether a buyback from an activist (whether framed as hushmail or otherwise) is in the best interests of the company and its stockholders, even if the motivations of the activist are self-interested.

There are many situations in which a buyback could be viewed as beneficial to the company, particularly if the company had previously authorized or was already considering repurchasing its stock and the opportunity exists to do so at a discount to market value. In situations in which the activist's board representatives demand that the company implement a business strategy or financial transaction that the other members of the board have clearly rejected, then a buyback may be the most expeditious path to a resolution of the controversy in the best interests of the company and its stockholders, particularly in situations where the activist board member has become disruptive to the proper function of the board and the company's ability to execute its business strategy.

Factors to Consider in Reviewing a Buyback of Stock From an Activist

Any stock buyback must be undertaken carefully, after appropriate review by the board of a number of important factors. If a board approves a repurchase of stock from an activist investor, it may face criticism from stockholders on the grounds that the opportunity to sell is not made available to all stockholders, the stock repurchase is motivated by management entrenchment, and the repurchase price is excessively high and therefore unfair to the company or its other stockholders.

It is well established that a Delaware corporation has the power to deal in its own stock and that the corporation may deal selectively with its stockholders in the acquisition of shares. As discussed below, the Delaware courts have long held that there are a variety of sound reasons why a board may agree to buy back its shares from a dissident stockholder, even at a premium to the current market price. Assuming that management entrenchment and stockholder disenfranchisement are not the primary purposes of the stock buyback, the board's decision to authorize the buyback should receive the benefit of the business judgment rule.

The Delaware Supreme Court has held that, if a stock buyback is not made in response to an actual or potential threat to corporate policy, then, "in the absence of evidence of fraud or unfairness, a corporation's repurchase of its capital stock at a premium over market from a dissident stockholder is entitled to the protection of the business judgment rule."[3]

The applicable standard of review of the board's decision will therefore turn initially on whether or not the purpose of the buyback was a defensive response against an actual or potential threat to corporate control. If it is viewed as defensive, the board's actions may be subject to enhanced scrutiny review under the Delaware law. The board should carefully consider and document the reasons for entering into the transaction in order to create an effective record of its rationale for approving the buyback. If the board is composed of a majority of outside directors, and advised by expert legal and financial advisors, it will help to establish that the board acted in good faith and made a reasonable investigation.

The following are several examples of typical stock buyback scenarios, and how the board's actions have been evaluated by courts in the past.

Buyback as a Favorable Financial Transaction

Often, the primary reason that the board decides to buy back shares from a dissident stockholder is because the board determines, in the exercise of its business judgment, that it is desirable from a capital allocation standpoint for the company to buy back stock at the present time. If a buyback makes financial sense, the board may determine that a repurchase of a block from a large stockholder who is eager to sell is a more efficient method to execute the repurchase than buying shares in the market. In that regard, if the company has an existing stock buyback program in place, the program may provide additional support for the board's position that the repurchase from the activist is being done for financial rather than defensive reasons. In the absence of entrenchment motives or an outside threat to control of the company, the board's decision should be entitled to the protection of the business judgment rule.[4]

Buyback to Address an Internal Rift Caused by a Dissident Stockholder

Another reason to buy back shares from a dissident stockholder could be that the stockholder is a source of controversy or friction with consequences adverse to the interests of the company and its stockholders generally, and the board wishes to buy out the stockholder to remove the source of the dispute. In the Delaware Supreme Court case of *Grobow v. Perot*,[5] referenced earlier, Perot was a director of General Motors, the chairman of GM's EDS division and also one of GM's most outspoken critics. Perot demanded that the GM board either give him full control of the EDS division, or buy him out of his GM stock. When GM offered to buy him out, Perot proposed that he be paid *double* the current market value for his shares. To Perot's surprise, GM agreed.

The court found that the primary purpose of the GM board's decision was not to "buy Perot's silence," but to "rid itself of the principal cause of the growing internal policy dispute over EDS's management and direction." Concluding that there was no outside threat to control of GM that would trigger a concern that the directors were acting in their self-interest, the court ruled that the business judgment rule was applicable and the board's actions were not subject to enhanced scrutiny.

Defensive Buybacks

In some cases, activist hedge funds may present an actual or potential threat to corporate policy and effectiveness. A buyout of the activist's shares may be considered a defensive action by the board in response to the threat, which could trigger a heightened standard of review of the board's actions. Under the Delaware law principles established in the well-known cases of *Unocal Corp. v. Mesa Petroleum Co.* and *Unitrin v. American General Corp.*, "if the directors initiated the repurchase in response to a threat to corporate policy related to a potential change in control of the corporation," then "a heightened standard of judicial review applies because of the temptation for directors to seek to remain at the corporate helm in order to protect their own powers and perquisites."[6]

The heightened standard of review under *Unocal/Unitrin* consists of two prongs. The first is "a reasonableness test, which is satisfied by a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[7] In reaching this determination, the independent members of the board, with the advice of legal and financial advisors, should make an investigation as to the threat posed, and be able to articulate clearly the nature of the threat.

Ownership by an activist hedge fund of a significant stock position may present a number of legitimate threats to corporate policy and effectiveness. Activist hedge funds often acquire large stock ownership positions through open market purchases, sometimes without adequate disclosure of their purchases and intentions. This could present a risk of "creeping control," in which effective control is acquired by the hedge fund without payment of a control premium to the other stockholders. There can also be a threat of "negative control," in which the hedge fund has the ability effectively to block corporate actions through voting power and other influence. Activists and other hedge funds also sometimes work collectively to acquire stock by means of "wolf pack" tactics, which can also present further threats of creeping control and negative control. [8]

The second prong of the *Unocal/Unitrin* analysis is a "proportionality test, which is satisfied by a demonstration that the board of directors' defensive response was reasonable in relation to the threat posed." The board's defensive actions must not be "draconian, by being either preclusive or coercive," and must fall "within a range of reasonable responses to the threat" posed.[9]

The repurchase of stock from an activist hedge fund, even at a premium, in response to a threat of creeping control or negative control is neither coercive nor preclusive. The other stockholders of the target are free to mount their own proxy contest and are free to vote their shares as they choose.

The second prong of *Unocal/Unitrin* also requires that the defensive action (in this case, the stock buyback) must be within a range of reasonable responses to the threat posed. The stock buyback would effectively eliminate the threat from the particular dissident stockholder, but the cost of doing so would have to be considered.

In *Polk v. Good*, the Delaware Supreme Court reviewed the settlement of a case involving a 9.9 percent stockholder of Texaco, known as the Bass group. The Bass group had suggested that it might increase its ownership to 20 percent or commence a hostile tender offer, at a time when Texaco's board viewed the stock as undervalued. The Texaco board identified a threat of creeping control, as well as a possible hostile offer at an unfair price. In response, Texaco bought back the Bass group's stake at a 3 percent premium to the current market price. The court found that the payment "seem[ed] reasonable in relation to the immediate disruptive effect and the potential long-term threat which the Bass group imposed. Clearly, that was a benefit to the company and most of its stockholders."[10]

In addition to buying back the activist's stock, the target company may also require that the activist enter into standstill and non-disparagement covenants. If the perceived threat is creeping control by the hedge fund, or negative control, then covenants preventing the activist from acquiring additional shares, or working alone or with other stockholders to influence control of the target through public criticism, should be considered to be reasonable responses to the threats posed.

Alternative Responses to Hushmailers

With the rise of greenmail in the 1980s, some companies adopted charter or bylaw amendments prohibiting the payment of greenmail. If hushmailing continues its rise, companies may consider adopting similar provisions to address hushmail, such as requiring disinterested stockholder approval of a stock repurchase. Institutional investors are likely to be supportive of these changes, because they should alleviate concerns about hushmail being paid for entrenchment purposes, as well as concerns that activist stockholders are getting special treatment not available to other stockholders.[11] By declaring that a hushmail payment is not an option, activist hedge funds seeking a quick payoff may look elsewhere for a more vulnerable target. At the same time, these changes may reduce the flexibility of the board in responding to hushmail demands and, in that sense, may reduce the utility and benefits of this strategy.

Conclusion

Activist hedge funds are increasingly seeking hushmail payments. In doing so, they risk being painted as villains rather than heroes. Nevertheless, if the target board believes that a repurchase of a significant block of stock from an activist is in the best interests of all stockholders, there is a path to do so under existing law.

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Endnotes

[1] In response to the widespread outbreak of greenmail in the mid-1980s, several states, including New York, Ohio and Pennsylvania, adopted corporate laws prohibiting the payment of greenmail without disinterested stockholder approval. Congress amended the Internal Revenue Code to provide for a 50 percent excise tax on greenmail payments in certain limited situations. In addition, some corporations took matters into their own hands, adopting charter and bylaw amendments prohibiting the payment of greenmail without disinterested stockholder approval.

[2] In the last 12 months, nine companies have repurchased shares from activists, which is more than the previous six years combined, according to data from *FactSet SharkWatch*.

[3] *See Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988); *See also Polk v. Good,* 507 A.2d 531, 536 (Del. 1986); *Kahn v. Roberts*, 679 A.2d 460, 465 (Del. 1996).

[4] *Kahn v. Roberts, supra,* at 464.

[5] *Grobow v. Perot*, *supra*, at 190.

[6] *Kahn v. Roberts*, *supra*, at 465.

[7] *Unitrin, Inc. v. American General Corp*., 651 A.2d 1361, 1373 (Del. 1995).

[8] *See* "*Third Point LLC v. Ruprecht* – Activism Confronts the Rights Plan," Latham & Watkins Client Alert, May 2014.

[9] *Unitrin*, *supra*, at 1367.

[10] *Polk v. Good, supra, at* 537.

[11] The voting policies of proxy advisory firms ISS and Glass Lewis both recommend in favor of anti-greenmail charter and bylaw provisions.