

THE ACTIVIST REPORT

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10 Questions with Ed McCarthy



Ed is a Senior Vice President of D.F. King & Co., Inc. in the firm's Extraordinary Events Group. Ed has guided clients through a wide range of governance and takeover challenges, including

contentious shareholder proposals, proxy contests, tender offers (solicited and unsolicited), and other corporate control matters. Representing both issuers and activists, throughout his career Ed has advised on over 100 contested elections.

13DM: You have notably represented activists like Bill Ackman and Carl Icahn. Tell us about your practice. Do you represent corporations too?

EM: I have been extremely fortunate to work with Bill and Carl, who are two of the most successful activist investors. Working with them for more than 20 years has also allowed me to continue relationships with some of their former protégés, including Keith Meister, Paul Hilal and Alex Denner. My practice has changed over the years from primarily representing activists to being evenly split between activists and issuers.

13DM: Describe the role of a proxy solicitor during a proxy contest. Talk about both the technical role and the advisory role.

EM: The job of a proxy solicitor is part advisor, part strategist and part psychiatrist.

Simply put, a proxy solicitor's technical role is to profile shareholders, their historical voting patterns and hot-button issues in proxy contests; coordinate the engagement process with institutional shareholders and proxy advisory firms; help facilitate voting for institutional holders and retail holders; and immediately identify vote returns.

In a contested election, a solicitor's role expands to include oversight of the entire solicitation strategy, including, but not limited to, messaging and the actual voting process. This generally starts with analyzing the shareholder base before and after public disclosure of an activist's overtures and running dynamic vote projections to determine the activist's likelihood of success. As every proxy contest is different, the solicitor will formulate the solicitation strategy that is likely to offer the best outcome in a given situation. This process includes making sure the messaging is consistent but geared to each constituency: proxy advisory firms, passive institutional investors, active institutional investors and retail shareholders. The strategy is rarely static, however, and the solicitor will generally need to alter it throughout the proxy contest, depending on how events unfold.

13DM: There has been a major decrease in the number of proxy fights over the past five to ten years. How has that changed your business?

EM: The decrease in proxy contests has not really changed my business. Most

companies are putting in place an activist defense team prior to an activist showing up. Consequently, we are now being retained by the activist or issuer well in advance of any public announcements. If there is a settlement or if the activist decides not to move forward with the campaign, that's still business for us, even if it is not reflected in the league tables.

13DM: Other than fewer proxy fights, what has been the biggest change in activism with respect to proxy solicitation over the past ten years?

EM: There have been a number of changes, the major ones being diminished influence for proxy advisory firms; increased ownership levels and influence for index funds; proxy contests by more traditional money managers (e.g., Neuberger Berman); an increased number of smaller activists; and, most importantly, the trend towards activists publicly releasing detailed white papers to support a call for change at an issuer.

13DM: How important is it to receive the recommendation of proxy advisory firms such as ISS and Glass Lewis in a proxy fight? Is it more important if you are the activist than the Company?

EM: It is less important today than it was a couple of years ago. One of the biggest misconceptions still in the market today is that all index funds will just blindly follow the ISS or Glass Lewis recommendation. For example, while each of Vanguard, BlackRock and SSgA receives both ISS and Glass Lewis reports, the actual voting

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decision is determined by each firm's proxy committee.

I believe that it is more important for the activist to receive support from ISS and Glass Lewis. The activist will not only receive the proxy advisory firm bump in votes, but it will also provide cover for certain institutional holders to vote with the activist.

13DM: There is a practice in the mutual fund world of loaning out shares for a fee, and as a result funds often are unable to get all of their shares back in time to vote them at contested elections. How rampant is this, what is a solicitor's role, if any, in making sure shareholders have all of their shares to vote and at what point do you know for sure how many shares a stockholder was able to recall?

EM: Stock loan activity is directly correlated to the company's short interest. At some companies this is not an issue. Trying to recall shares on loan is like a game of musical chairs: when the music stops, someone will not have their voting rights on the record date. This is not a concern limited to mutual funds and ETFs; it can affect hedge funds, company insiders and, at times, the activists themselves.

As soon as we are retained by a client, high on the checklist is to make sure that the client's shares and potential friendly

investors are free and clear to vote. This has to be done well in advance of the record date. If we are representing the dissident, we reach out to hedge funds and event-driven investors to notify them of the record date and urge them to contact their prime broker(s)/custodian(s) to recall the shares to provide full voting authority by the record date. With most institutional holders, we will not be in a position to know how many shares were successfully recalled until after the record

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date. With some institutional holders, quite frankly, we may not know until they actually execute their vote.

13DM: There are stock watch companies and professionals who assist in proxy fights by identifying the current stockholders of companies as opposed to the holders reported in periodic SEC filings. How important are stock watchers in proxy fights and is it an easier task when working for the Company than the activist?

EM: A good stock watch firm can be an extremely important part of an overall proxy campaign. It's best to hire a stock

watch firm well in advance of the record date, so that it will be familiar with the shareholder base. The basic job of a stock watch company is to identify movements in the shareholder base that occur between the filing periods (13F filings have to be disclosed no later than 45 days after each quarter). This allows the issuer or activist to solicit proxies from the most current shareholder base.

A good stock watch firm can also identify the number of shares that each of the large institutional holders has on stock loan – if a shareholder has shares out on stock loan as of the record date, the shareholder cannot vote the shares on loan. This is important for projecting the potential success of a campaign in the early stages.

Performing stock watch is definitely easier for the issuer, which receives more detailed information from custodians than the activist does.

13DM: There has been talk about the U.S. adopting a universal ballot in director elections. How would that change the way directors are elected? Would it tilt the tables towards or away from activists?

EM: You cannot generalize that a universal ballot is more favorable for an activist or an issuer – it is dependent upon the circumstances.

I could make the case that a universal ballot would potentially harm activists by allocating votes to management nominees who otherwise would not

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have been allocated votes. For example, let's say that an activist is running a short slate, soliciting for three out of nine seats. Under the current short slate rule, the activist would have to disclose that its proxy would be a vote for all management nominees except for the three nominees it is targeting. If a shareholder wished to vote for only two activist nominees, the shareholder would have to vote the activist's proxy card, voting for the two nominees and withholding on the third nominee. The three targeted management nominees would not receive any of the shareholders votes, but the six unopposed management nominees would receive the votes. If a number of institutional holders voted this way, one possible outcome would be that two of the activist nominees would receive a much greater amount of support than the three management nominees being targeted. Also, it would become a numbers game if the third activist nominee gets elected, albeit with fewer votes than the two activist nominees but more votes than the three targeted management nominees. A universal ballot would eliminate this outcome because shareholders would be able to allocate their votes for nine out of the 12 nominees on the ballot.

13DM: You just represented Mantle Ridge in their proxy vote at CSX approving the compensation package of Hunter Harrison, the CEO installed by Mantle Ridge. That was a unique situation. How did that differ from a plain vanilla proxy fight?

EM: At the highest level, this situation was very unusual. You had a seasoned activist, Paul Hilal, and a sophisticated Board who both were, and who each understood the other to be, focused exclusively on the long-term best interests of the company. Soon after Mantle Ridge surfaced in mid-January, a constructive relationship formed that led to a settlement in just

seven weeks.

Among other things, the settlement involved replacing the incumbent CEO and adding five new directors to the Board. The new CEO, railroad legend Hunter Harrison, was installed in early March. Thanks to great improvements he has made to date and anticipation of continued strong execution, CSX's stock is up 45% (\$15 billion of market cap) since news of Mantle Ridge's involvement surfaced, greatly outperforming the industry. All in all, this was a terrific result for the shareholders.

The quick settlement left one vital question outstanding – whether the Board would satisfy the reimbursement requirements of incoming CEO Hunter Harrison. Mr. Harrison required reimbursement of \$84 million out of the \$90 million of fully-vested compensation and benefits (it was earned and unconditionally his) he forfeited in order to free himself from his prior employer's non-compete clause. The Board would not reimburse Mr. Harrison until shareholders voted on a non-binding proposal either supporting or opposing reimbursement. That vote was scheduled for the June Annual Meeting. Mantle Ridge, the Board and Mr. Harrison agreed that it was in the Company's best interest for Mr. Harrison to start in March rather than wait for the Board's reimbursement decision after the Annual Meeting. The stakes were high, as Mr. Harrison made clear that he would promptly resign if the reimbursement were not made.

This made for a highly unusual proxy solicitation. As more fully detailed in Mantle Ridge's proxy solicitation materials, it involved a confusing and unprecedented fact pattern that involved an activist effectively buying a CEO from one Company to present him to another; a vote on a very large reimbursement figure (\$84 million) that was misconstrued as an excessive "make whole" of foregone comp opportunity; a tax indemnity that

could be confused with a "gross up"; a reimbursement structure that could be misconstrued as profiteering by Mantle Ridge; a Board that presented a non-binding vote without a recommendation; and an activist with his own proxy card recommending for reimbursement.

Over many weeks of an intensive solicitation effort, we explained this complicated and unprecedented fact pattern to the proxy advisory firms and institutional shareholders. We were pleased that all three proxy advisory firms recommended shareholders vote in support of the reimbursement. We were further pleased that more than 93% of the votes cast at the Annual Meeting were in support of our proposal. If the advocate puts in the effort to thoroughly educate the proxy advisors and shareholders, those two constituencies can master even the most challenging of fact patterns, and come to the right answers. Everyone wins.

13DM: What do you see as the major innovations and developments in proxy voting over the next five years?

EM: This is the major one for me: implementation of a universal ballot in proxy contests for board seats. Due to the changes in the administration it is unlikely that this will be addressed at the federal level in the near future. Although shareholders may take action through the 14a-8 process seeking companies to adopt universal ballots in contested elections. Institutional holders have long clamored for the implementation of the universal ballot, which would allow them to pick and choose nominees from the issuer's slate and the activist's slate. I was lucky enough to be involved in one of the only proxy contests with U.S. holders that allowed for a universal ballot, representing Pershing Square Capital Management against Canadian Pacific.

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