Cravath Quarterly Review
M&A, Activism and Corporate Governance

Volume 1 | Issue 2

Q2 2019

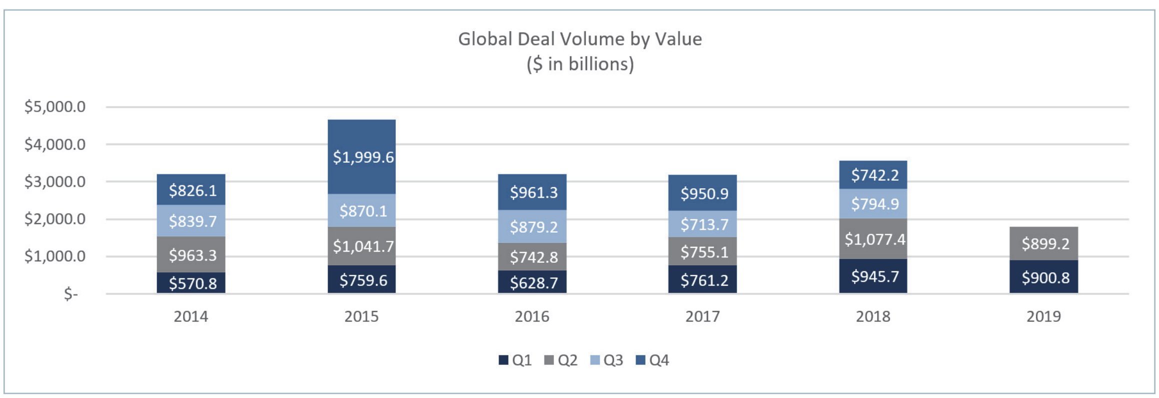
Mergers & Acquisitions

TRENDS[1]

Despite lower levels of deal making (both in terms of number of deals and total deal values) relative to near peak M&A activity by quarter in Q2 2018, Q2 2019 was another strong quarter for global M&A. The strong quarter helped fuel a robust first half that came just shy of matching the first half of 2015 for the second most active 1H in terms of deal making by dollar value since 2014. However, despite the strong first half in 2019, global economic factors contributed to significant shifts in the geographical distribution of deal making. Geopolitical tensions and protectionist trade policies are cited as causing domestic M&A to account for a larger share of global deal making—67% in 1H 2019 relative to an average of 61.3% per year since 2010. In this context, the United States captured a record share of global M&A activity in the first half of 2019 (53.2%), driven in part by the strength of the U.S. deal economy (up 14.6% relative to 1H 2018 in terms of deal value), as well as weak M&A activity in Europe and Asia (down 38.8% and 34.2%, respectively, relative to 1H 2018). Finally, Q2 2019 again saw significant declines in deal count despite above average total deal value, resulting in higher value deals on average in Q2 and 1H 2019 relative to deal values over the last five years.

Global 1H 2019 Deal Making Nearly Matches Second Highest in Last Five Years (Despite YoY Declines), Due to the Strength of Q1 and Q2 Compared to Quarterly Averages; Megadeals Drive Overall M&A Market

Q2 2019 featured $899 billion worth of deals across 3,839 transactions, a 16.5% reduction in terms of total deal value relative to near peak quarterly levels of deal activity in Q2 2018. Despite YoY declines of 11% relative to the first half of 2018, 1H 2019 featured a Q1 and Q2 that were each ~5% above quarterly averages in terms of deal value since 2014, which resulted in 1H 2019 nearly matching the second most active first half for M&A since 2014 in terms of deal value ($1.8 trillion worth of deals across 8,201 transactions). Notably, the number of transactions continued to decline in Q2 2019 (3,839 transactions relative to a quarterly average of 4,740 transactions since 2014). This translated to average per deal values of $234 million in Q2 2019, relative to average per deal values of $181 million since 2014. Megadeals continued to drive the overall M&A market—Q2 2019 featured 15 megadeals (greater than $10 billion), with a 2019 first half that featured 24 megadeals overall that accounted for approximately 43% of overall deal value. The importance of megadeals as a driver of overall M&A activity was particularly pronounced in the U.S., which featured 19 megadeals valued at $569.2 billion in 1H 2019, driving a remarkable 59.5% of deal value by volume for the region. As companies in many sectors continue to see size and scale as an imperative to effective competition, it will be interesting to see if the pace of megadeal activity continues during the balance of the year.



Source: Mergermarket

[1] All data regarding M&A activity from Mergermarket unless otherwise indicated. Deal values and volume may vary across our newsletters due to continuous updates to the M&A activity sources.

Cross-Border Deals Decline in 1H 2019; Domestic Deals Take Larger Share of Global M&A

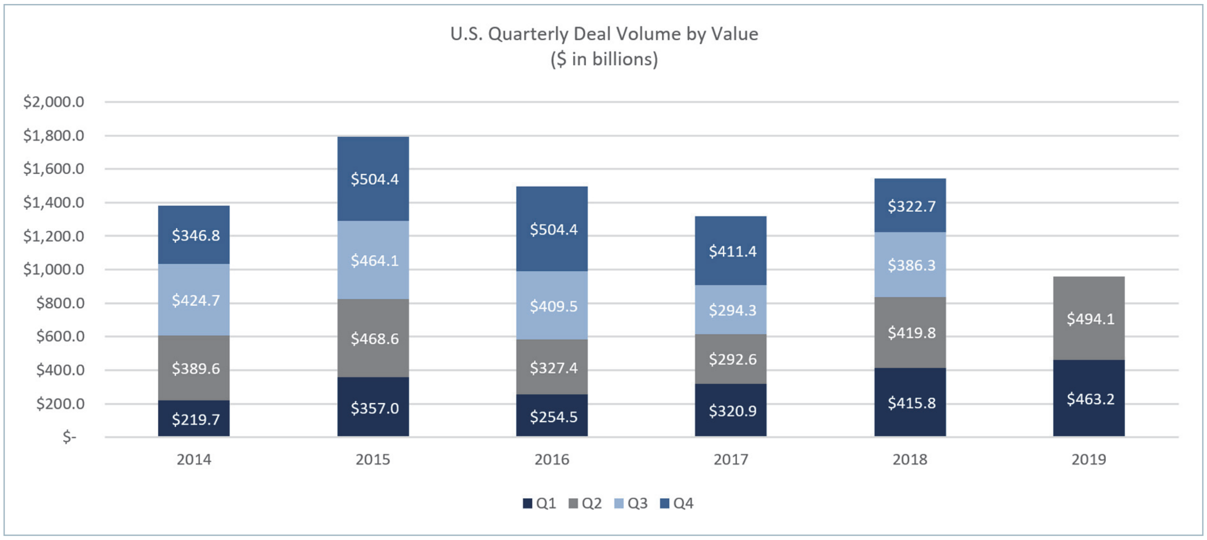
The second half of 2018 saw a marked slowdown in cross-border deal activity due to a number of factors, in particular the effect of uncertain political and geopolitical conditions. Uncertainty in these areas has not abated, and these conditions have continued to erode cross-border deal making, with 1H 2019 featuring $594.7 billion worth of cross-border deals, a 22% reduction relative to 1H 2018. Deal activity also reflects this trend on a regional basis, with the dollar value of deal making in Europe, Latin America, and Asia Pacific (excluding Japan) declining 38.8%, 27% and 36%, respectively, relative to the first half of 2018. The extent of this decline is somewhat skewed by the strength of the first half of 2018—in terms of average 1H deal values since 2009, European deal making was down only ~1.66% and Asia Pacific (excluding Japan) was actually up ~1.53%—but overall, the downward impact on non-U.S. M&A activity remains. Japan was somewhat of an exception, recovering from a slow start to 2019 to post a 2.4% increase in M&A activity by total deal value relative to the first half of 2018, but overall Japan deal making was down by ~20% in terms of average 1H deal values for the region since 2009. The Middle East and Africa was a major exception to declining levels of M&A activity in non-U.S. markets, posting a 222% increase in deal activity by total deal value relative to 1H 2018, although this figure was skewed dramatically by Saudi Aramco's $70.4 billion acquisition of 70% of Saudi Basic Industries Corporation (Sabic) in the first quarter of the year, which comprised 62% of the overall deal value in the region for the first half of 2019. Taken together, as previously indicated, this resulted in domestic M&A comprising an outsized share of global M&A activity by value (67% in the first half of 2019) relative to historical averages (61.3% per year since 2010), and the U.S. market garnering a record 53.2% of global M&A activity by value.

Robust Quarter for Private Equity Despite YoY Declines; Europe, Middle East and Africa (EMEA) and U.S. Lead Regional Private Equity Activity

Despite reduced private equity acquisitions by value in Q2 2019 relative to record levels in Q2 2018, as well as an overall decline in private equity acquisitions by value in 1H 2019 relative to 1H 2018 by 23%, global private equity acquisitions increased relative to Q4 2018 ($111 billion worth of deals) and Q1 2019 ($111.5 billion worth of deals), posting $133.6 billion in total deal value in the second quarter of this year. Overall, global private equity acquisitions in 1H 2019 consisted of $245.1 billion worth of deals across 1,494 transactions, with U.S. and EMEA markets leading the way—U.S. private equity acquisitions featured $111.6 billion worth of deals across 608 transactions, while EMEA private equity acquisitions posted $90.5 billion worth of deals across 647 transactions. Significantly, 1H 2019 featured three mega private equity acquisitions, matching the number of mega private equity acquisitions in all of 2018 and further demonstrating the strength of the private equity market so far in 2019.

Continued Growth in the U.S. M&A Market by Value as the U.S. Claims an Outsized Share of Global Deal Volume

In the United States, Q2 2019 featured $494 billion worth of deals across 1,200 transactions, an ~18% increase by value relative to Q2 2018 and a ~7% increase relative to Q1 2019. This continued growth in U.S. deal making resulted in $957.3 billion worth of deals across 2,530 transactions in 1H 2019, up 14.6% by value relative to the $835.6 billion worth of deals (3,201 transactions) posted in 1H 2018 and second only to the second half of 2015 in terms of deal value over any half-year period since 2001. As previously mentioned, megadeals were a major driver of overall U.S. activity, as 19 megadeals worth a collective $569.2 billion comprised 59.5% of deal volume by value in 1H 2019. Despite reduced cross-border M&A on a global level, U.S. inbound M&A actually saw strong growth in the first half of 2019 relative to the first half of 2018, featuring YoY growth of 19.8% in terms of deal value ($137 billion worth of deals across 441 transactions), relative to the first half of 2018 (which featured $114.3 billion worth of deals across 521 transactions). However, inbound M&A in the U.S. arose disproportionately from certain regions and varied across sectors. Both Europe and Asia increased their inbound investment into the U.S. by 26.4% and 53.2% in terms of M&A deal value, respectively, relative to 1H 2018. But certain sectors and subsectors, such as semiconductors, that have been the subject of heightened CFIUS scrutiny saw decreased Asian inbound investment despite increased investment from European buyers, and Chinese outbound M&A on the whole in the U.S. reached 10-year lows in the first half of the year due to increased regulatory scrutiny and lack of clarity around closing certainty when dealing with Chinese acquirers.

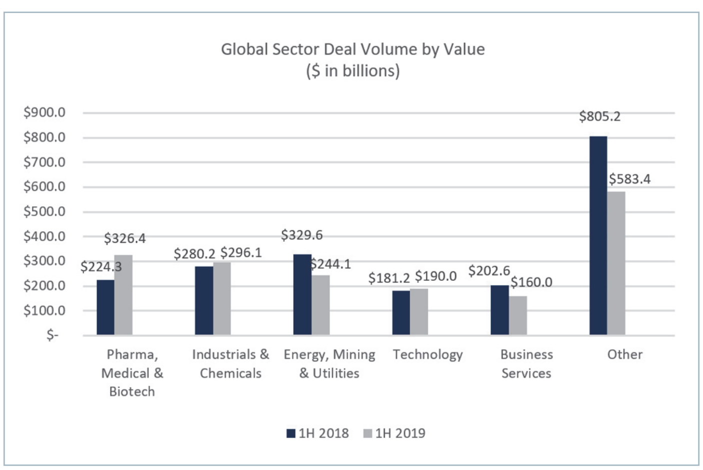


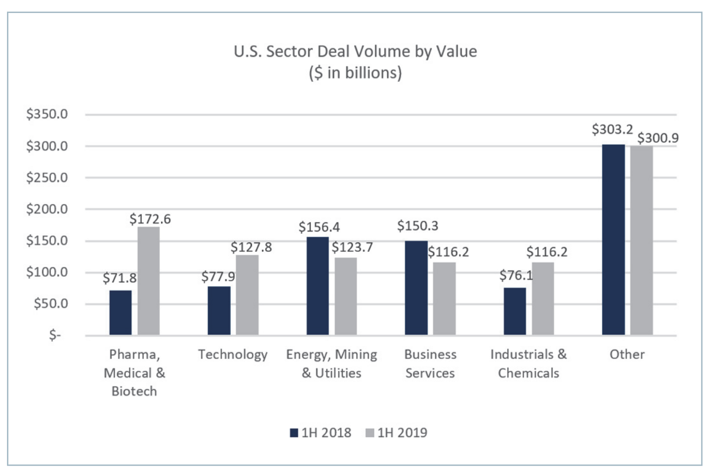
Source: Mergermarket

Major Activity In Certain Sectors

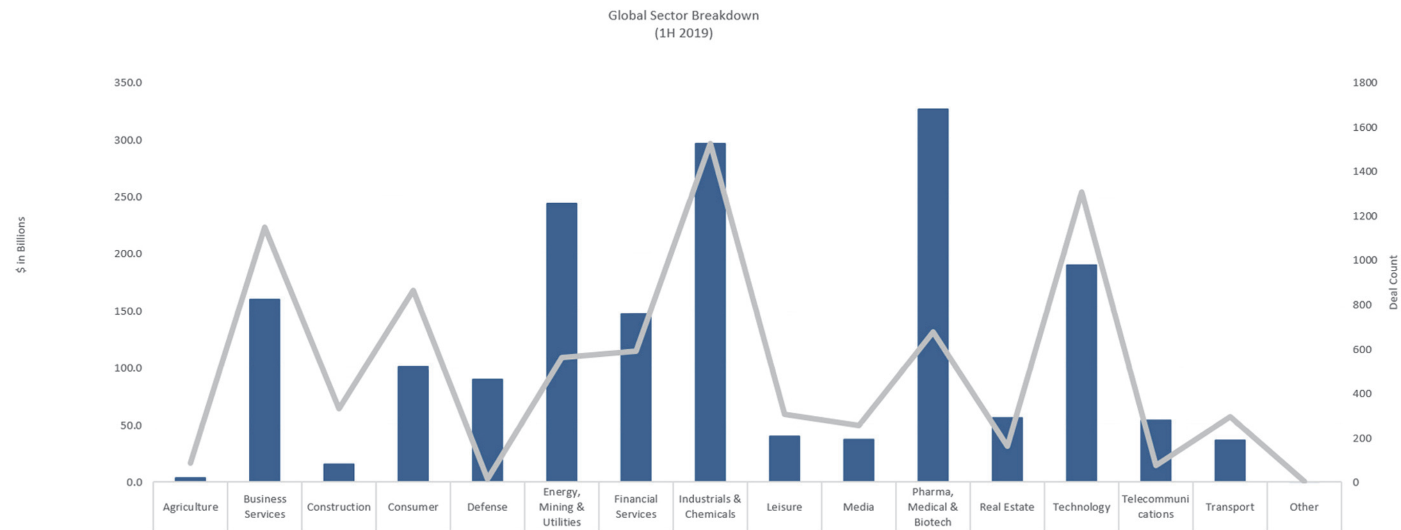
In terms of global deal value, Pharma, Medical & Biotech led the way in 1H 2019, featuring $326.4 billion worth of deals (677 transactions) that accounted for 18.1% of deal value in the first half of 2019, including two of the five largest deals so far this year—Bristol-Myers Squibb's $89.5 billion acquisition of Celgene Corporation and AbbVie's $86.3 billion acquisition of Allergan plc. Industrials & Chemicals was the second most active sector, featuring $296.1 billion worth of deals (1,525 transactions) that accounted for 16.5% of deal value, of which Saudi Aramco's $70.4 billion acquisition of 70% of Sabic was the largest deal in the sector. Energy, Mining & Utilities was in the top five of sector activity, featuring $244.1 billion of transactions (13.6% of deal value across 560 transactions), of which Occidental Petroleum's $54.4 billion acquisition of Anadarko Petroleum in Q2 2019 was the largest deal in the sector for the year.

Technology and Business Services were the two other most active sectors in terms of deal value in the first half of 2019, featuring $190 billion (10.6% of deal value across 1,307 transactions) and $160 billion worth of deals (8.9% of deal value across 1,149 transactions), respectively. Notably, the largest deal in Q2 2019 was United Technologies' $88.9 billion combination with Raytheon Company—a deal that was driven by the goal to create scale in the Aerospace and Defense industry, leading commentators to speculate that such transactions could continue among other companies in the sector in order to better compete. Finally, in terms of M&A growth by sector, Technology deals have seen a significant increase in terms of volume, with 1H 2019 featuring 1,307 deals (15.9% of deal activity by volume and its highest share on record for any half-year period) due in part to increased demand for data analytics and cloud services, as well as the attractiveness of technology companies to private equity buyers.



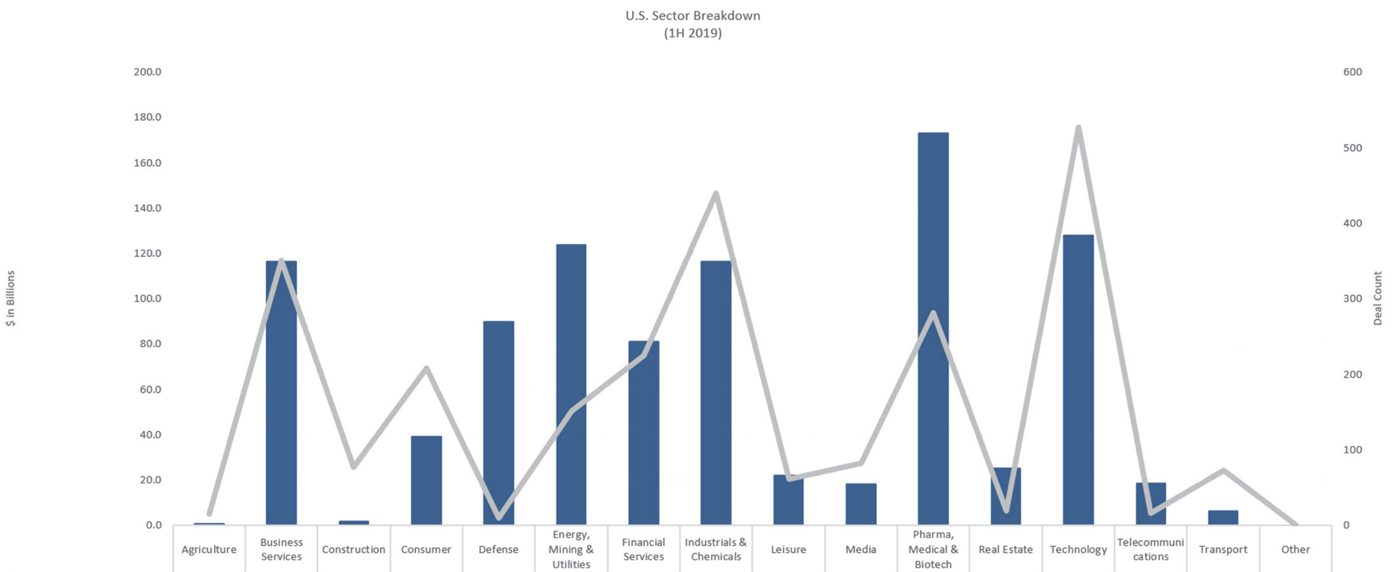


Source: Mergermarket



	Agriculture	Business Services	Construction	Consumer	Defense	Energy, Mining & Utilities	Financial Services	Industrials & Chemicals	Leisure	Media	Pharma, Medical & Biotech	Real Estate	Technology	Telecommunications	Transport	Other
Value ($ in billions)	3.7	160.0	15.7	101.2	90.1	244.1	147.3	296.1	40.2	37.7	326.4	56.1	190.0	54.4	36.5	0.2
Deal Count	87	1149	331	862	15	560	590	1525	305	257	677	161	1307	77	296	2

Source: Mergermarket



	Agriculture	Business Services	Construction	Consumer	Defense	Energy, Mining & Utilities	Financial Services	Industrials & Chemicals	Leisure	Media	Pharma, Medical & Biotech	Real Estate	Technology	Telecommunications	Transport	Other
Value ($ in billions)	0.5	116.2	1.7	39.1	89.8	123.7	80.9	116.2	21.7	18.0	172.7	24.8	127.8	18.2	6.2	0.0
Deal Count	15	350	77	208	9	151	224	439	61	82	281	19	526	16	72	0

Source: Mergermarket

LEGAL DEVELOPMENTS

Cases

Q2 featured a number of notable cases for M&A practice.

Olenik v. Lodzinski, No. 392, 2018 (Del. April 5, 2019): In this case, the Delaware Supreme Court provided useful guidance regarding what is required to satisfy the "up front" requirement under *MFW*,[2] which provides that a conflicted controller transaction will be reviewed under the business judgment rule if, at the outset, the transaction is conditioned on the approval of both an independent special committee and a majority of the minority stockholders. In *Olenik*, the Delaware Court of Chancery found that the controller-led merger was compliant with the "up front" requirement of *MFW* despite the fact the parties engaged in months of negotiations prior to the *MFW* conditions being imposed. Finding that these lengthy negotiations, "never rose to the level of bargaining" and instead "were entirely exploratory in nature", the trial court applied the business judgment standard and dismissed the case. The Delaware Supreme Court disagreed. Applying the guidance supplied by *Flood v. Synutra International, Inc.*[3]—a case that was decided while the parties briefed the appeal in *Olenik*—which requires *MFW* protections be put in place prior to the start of "substantive economic negotiations", the Court found that the "up front" requirement was not met and remanded the case for review under the more exacting "entire fairness" standard. In reaching this conclusion, the Delaware Supreme Court emphasized key facts in *Synutra* that supported the "up front" requirement being satisfied, noting the *MFW* conditions were put in place, "at the germination stage of the Special Committee process", prior to the selection of advisors, the start of due diligence and the commencement of economic negotiations. Additionally, the Court in *Olenik* also provided insight into what types of activities constitute substantive economic negotiations. The Court concluded that the facts supported a pleading-stage inference that, "the preliminary discussions transitioned to substantive economic negotiations when the parties engaged in a joint exercise to value [the target]", stating that it was "reasonable to infer that these valuations set the field of play for the economic negotiations to come by fixing the range in which offers and counteroffers might be made." This inference was further supported by the fact the initial and final offers fell within that valuation range. For practitioners, this serves as a reminder that even absent explicit price negotiations, "substantive economic negotiations" can be deemed to have taken place, particularly if they establish a framework for valuation that serves as the basis for future price negotiations.

Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., No. 368, 2018 (Del. April 16, 2019): In this closely watched appraisal case, the Delaware Supreme Court—in a unanimous *per curiam* decision that sharply criticized the trial court judge—reversed the Delaware Court of Chancery's fair value determination in the statutory appraisal proceeding arising out of Hewlett-Packard's ("HP") acquisition of Aruba Networks, Inc. ("Aruba"). The Delaware Supreme Court held that Aruba's fair value was $19.10 per share, which was calculated as the deal price minus the synergies paid for by HP in the transaction, as estimated by Aruba. In doing so, the Delaware Supreme Court held that the Court of Chancery abused its discretion by relying on the 30-day unaffected market price of Aruba's stock before the acquisition was publicly announced (which resulted in a determination by the Chancery Court of $17.13 per share as Aruba's fair value). In the opinion, the Delaware Supreme Court clarified prior holdings in recent appraisal litigation and affirmed the Delaware Supreme Court's longstanding view that deal price provides strong evidence of fair value when a public company with an efficient trading market is sold in a transaction resulting from an open sales process conducted at arm's length. The Court reiterated this view even if a sales process results in only a few bids or only one bidder. The Court also relied on extensive Delaware precedent and the appraisal statute in excluding the synergies paid for by the acquirer in the deal price in determining fair value.

Varjabedian v. Emulex Corp., 888 F.3d 399 (9th Cir. 2018), *cert. dismissed* 587 U.S. ___ (2019): At issue in this case was whether the 9th Circuit—in conflict with five other Circuit Courts of Appeals—correctly held that negligent misstatements or omissions in connection with a tender offer violate Section 14(e) of the Exchange Act (as opposed to misstatements or omissions made with "scienter"). After initially granting cert and hearing oral argument, the Supreme Court dismissed the case as improvidently granted. From a practitioner perspective, the dismissal now leaves open the possibility for claimants to pursue actions under Section 14(e) based on negligent misstatements

[2] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 653 (Del. 2014).

[3] 195 A.3d 754 (Del. 2018).

or omissions in the context of tender offers in the 9th Circuit (as opposed to the higher "scienter" standard applied by other courts). In the case, the petitioners argued that this will effectively make the 9th Circuit the de facto forum for these types of actions, and that a larger volume of cases will now survive the pleadings stage and enter into costly discovery. Aside from the immediate implications, interestingly, the cert petition also crafted the issue in order to argue a more fundamental question—whether Section 14(e) grants a private right of action at all—despite the fact this was not argued before the 9th Circuit panel and is not subject to circuit conflict. As commentators note, this seemingly was an attempt by petitioners to capitalize on recent Supreme Court precedents that are skeptical about inferring private rights of action under federal securities laws.[4] And commentators have noted that at oral argument some of the justices questioned whether such a private right of action should exist at all under Section 14(e).[5] As such, the dismissal leaves open the possibility the U.S. Supreme Court could consider this larger question in the future if properly presented.[6]

Notable Moves

While happening in July, we would be remiss if we did not refer to the retirement of Chief Justice Leo Strine from the Delaware Supreme Court, which was announced on July 8, 2019. One of the most influential jurists in corporate law, Chief Justice Strine wrote some of the most important opinions in M&A and corporate governance, shaping the manner in which M&A practitioners structure and document transactions, and advise boards of directors.

Regulatory

In May, the Securities and Exchange Commission ("SEC") proposed amendments to its rules governing financial disclosure requirements in connection with business acquisitions and dispositions.[7] The proposed amendments are "intended to improve the financial information made available to investors about acquired or disposed businesses, facilitate more timely access to capital and reduce complexity and compliance costs related to these financial disclosures," and would (among other things):

- revise the "investment test" and the "income test" (two tests that are used to determine the level of disclosure required based on the significance of an acquisition or disposition), expand the use of pro forma financial information in measuring significance, and conform the significance threshold and tests for a disposed business (which would result in the significance threshold for dispositions being raised from 10% to 20%);

- change the period for required financial statements of the acquired business to cover up to the two most recent fiscal years rather than up to the three most recent fiscal years;

- permit disclosure of abbreviated financial statements that omit certain expenses for certain acquisitions of a component of an entity;

- clarify when financial statements and pro forma financial information are required;

- permit the use in certain circumstances of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board; and

- eliminate the requirement to provide separate acquired business financial statements once the business has been included in the registrant's post-acquisition financial statements for a complete fiscal year.[8]

As a general matter, commentators view the proposed amendments, which are part of the SEC's ongoing disclosure effectiveness initiative, as a positive for capital formation by easing disclosure requirements while also ensuring availability of meaningful information for investors.

However, the proposed amendments would also amend the pro forma financial information requirements to require that pro forma financial information include disclosure of reasonably estimable synergies and transaction effects. This proposed amendment raises many questions and poses difficulties that are not answered or addressed in the release, including:

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[4] Kevin Russell, *Practice Pointer: Digging into DIGs*, SCOTUSblog (Apr. 25, 2019, 1:21 PM), https://www.scotusblog.com/2019/04/practice-pointer-digging-into-digs/.

[5] Ronald Mann, *Justices pass on opportunity to define liability for inadequate disclosures about tender offers*, SCOTUSblog (Apr. 23, 2019, 2:50 PM), https://www.scotusblog.com/2019/04/justices-pass-on-opportunity-to-define-liability-for-inadequate-disclosures-about-tender-offers/.

[6] *See id.*

[7] The proposed amendments are to Rules 3-05, 3-14, and Article 11 of Regulation S-X, as well as related rules and forms, and also include proposed new Rule 6-11 of Regulation S-X and amendments to Form N-14 to govern financial reporting for acquisitions involving investment companies.

[8] Press Release, U.S. Securities and Exchange Commission, SEC Proposes to Improve Disclosures Relating to Acquisitions and Dispositions of Businesses (May 3, 2019); Amendments to Financial Disclosures about Acquired and Disposed Businesses, 84 Fed. Reg. 24,600, 24,603 (proposed May 28, 2019).

- how to reconcile the fact that pro forma financial statements are a backwards-looking set of financial statements that cover only the most recently completed fiscal year and any required interim periods, while synergies are forward-looking estimates that may be achieved over a several year period;

- that the costs of achieving synergies may be more significant in early periods, while the benefits of those synergies may be achieved in later periods, and the amount of synergies to be obtained may not be constant in all future periods;

- that synergy estimates are inherently uncertain and do not necessarily lend themselves to the specific line-item allocation required to present them in pro forma financial statements;

- that synergies may be material in the context of a particular transaction, and immaterial in the context of another, and the proposed amendments would require synergy estimates to be reflected in pro forma financial statements irrespective of materiality; and

- that the preparation of pro forma financial statements can be a long-pole in transaction timetables, and that this requirement will make the preparation of pro forma financial statements more difficult.

Comments are due to the proposed rules on July 29, 2019.

Activism[9]

In July 2019, Lazard released its H1 2019 Review of Shareholder Activism, which offers key observations regarding activist activity levels and shareholder engagement in the first half of 2019.

Key findings / insights from the report include:

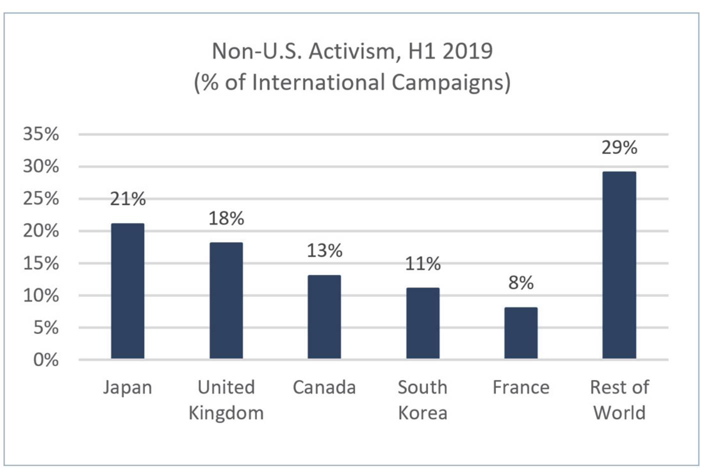
- lower levels of activism relative to record H1 2018, but on pace with activism activity in recent years;
- M&A thesis continues to be a major theme, arising in nearly 50% of all campaigns;
- international activism reaches record highs, with Japan as the most active international jurisdiction;
- active managers continue to be increasingly vocal on important corporate matters, showing they will no longer wait for shareholder votes to make their positions known; and
- passive managers continue to drive culture and purpose, remaining focused on environmental, social and governance issues (ESG).

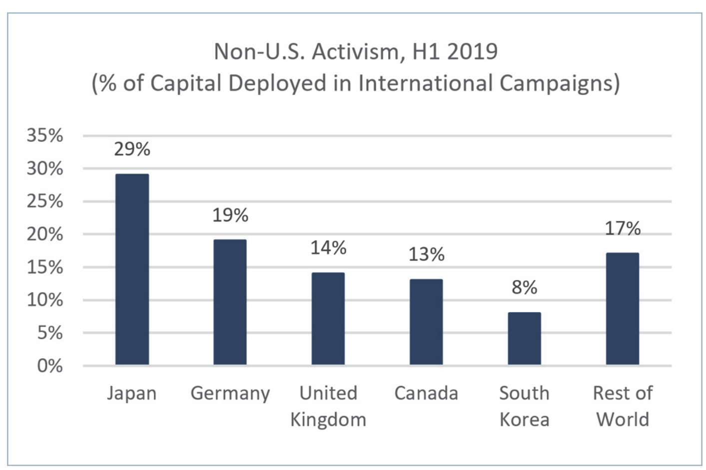
TRENDS

Campaign Activity Down Relative to Peak Levels in Q2 and H1 2018, But Consistent with Historical H1 Levels; Fewer Board Seats Won, with Wins Occurring Primarily Through Settlements
Q2 2019 featured 50 campaigns initiated against 46 companies globally, down relative to Q2 2018's peak levels, which featured 73 new campaigns against 65 companies globally. On the whole, H1 2019, which featured 107 campaigns against 99 companies globally, was down relative to H1 2018, which featured 142 campaigns against 132 companies globally. Despite slight decreases, levels of activism remained on par with recent years, with the 99 companies targeted in H1 2019 just below the H1 average of 104 companies targeted from 2014-2018.

For the quarter, global capital deployment towards new campaigns was significantly down, at $10.6 billion, relative to heightened Q2 2018 levels of $19 billion. This translated to an H1 2019 that saw a corresponding dip in capital deployments towards new campaigns, with $22 billion deployed in H1 2019 relative to average H1 capital deployment from 2016-2018 equal to $31.1 billion. As a general matter, 2017 and 2018 saw significant increases in activism as compared to prior years, and first half figures for new capital deployed in H1 2019 were in fact nearly double new capital deployed in 2016, which featured $11.5 billion deployed towards new campaigns. However, on the whole activism remains down relative to quarterly averages since 2016, with the $10.6 billion in capital deployed towards new campaigns down by 12% relative to the quarterly median over that timeframe.

A total of 42 board seats were won by activists in Q2 2019, fewer than the 54 board seats that were won in Q2 2018. Overall, 81 board seats were won in H1 2019, down compared to the 119 board seats that were won in the first half of 2018 and the mean number of H1 board seat wins of 129 by activists from 2014-2018. Of the 81 board seat wins in H1 2019, 74 were secured via settlement, of which 42 board seats were secured outside a contested proxy process, a continuation of the trend away from proxy fights as a means to settle activist situations.





Source: Lazard, *Review of Shareholder Activism – H1 2019*

[9] Activism data from Lazard, *Review of Shareholder Activism – H1 2019*, which includes all data for campaigns conducted globally by activists at companies with market capitalizations greater than $500 million at the time of campaign announcement; companies that are spun off as part of the campaign process are counted separately.

International Activism Reaches Record Highs in Terms of Capital Deployed Against Non-U.S. Targets; APAC Activism Sees Major Uptick, with Japan as the Most Active Non-U.S. Jurisdiction

H1 2019 saw new campaigns against non-U.S. targets account for 45% of global capital deployed, up compared to 37% in H1 2018. In Europe, $4.4 billion was deployed towards 19 campaigns in H1 2019, accounting for 20% of global capital deployed—a decrease relative to 2018, in which capital deployed in Europe comprised 25% of the overall total, and a 57% drop relative to H1 2018 (which saw $10.2 billion of capital deployed against European companies). When compared to H1 averages from 2014-2018, the drop in capital deployed in Europe was somewhat less dramatic, although it is still significant at 41%, reflective of the recent trend of activists targeting smaller European companies and focusing on existing positions.

In contrast, APAC companies (including all of Asia, Australia and New Zealand) saw increases in capital deployed in 2019, with $3.9 billion deployed in 13 new campaigns, accounting for 18% of global capital deployed, relative to 8% in 2018. Overall, this was a significant increase relative to the $3.1 billion of capital deployed against APAC companies (including all of Asia, Australia and New Zealand) in H1 2018, and reflects a remarkable uptick relative to H1 averages for capital deployment from 2014-2018, which have featured on average $2.02 billion in capital deployed against APAC companies (resulting in an increase of ~93% relative to these historical averages).

On the whole, Japan was the leader for non-U.S. activism activity—both in terms of the percentage of international campaigns and percentage of capital deployed against non-U.S. companies—and featured notable campaigns against companies such as Nissan Motor Company, Nomura and Sony.

M&A-Related Campaigns Continue To Be a Major Theme

M&A-related objectives comprised 46% of all activist campaigns in H1 2019, a significant increase relative to the period from 2014-2018, in which M&A objectives comprised only one-third of all campaigns. The most common M&A objectives were relatively evenly split across three categories in H1 2019—"bumpitrage" and opposition to deals (35%), break-up / divestiture (33%) and sale of the company (32%).

Notable examples of M&A-related campaigns in the first half included:

- Icahn targeting Caesars Entertainment, calling for a strategic review and sale of the company, resulting in a settlement with Icahn for three board seats and an ultimate agreement with Eldorado Resorts to acquire Caesars for $8.6 billion.

- Icahn targeting Occidental Petroleum, opposing the company's proposed acquisition of Anadarko and demanding a shareholder vote on the deal;

- Third Point targeting Sony, calling on the company to focus on its entertainment business by spinning off its semiconductor business and selling its stakes in Sony Financial, M3, Olympus and Spotify; and

- Pershing Square / Third Point, opposing United Technologies' planned merger with Raytheon.

Active Managers Continue To Be Vocal on Corporate Matters, Including Launching Activist Campaigns; Passive Managers Maintain Focus on ESG

In H1 2019 active managers continued to be vocal on major corporate matters, including wading into activist campaigns by publicly stating their views, as well as by launching activist campaigns themselves. For example, in the activist campaign involving EQT and the Rice Group, T. Rowe Price—EQT's largest shareholder—came out against EQT, stating that it would vote in favor of the Rice Group's dissident slate to remove more than 50% of the EQT directors, which ultimately resulted in the Rice Group defeating EQT's slate of directors and taking control of the board. Additionally, campaigns at Methanex and Verint saw M&G Investments and Neuberger Berman, respectively, nominate dissident director slates due to concerns with issues such as corporate governance and corporate strategy, ultimately resulting in settlements with these active managers.

Passive managers and other shareholders also continued to focus on environmental, social and governance (ESG) related issues, with ESG-related proposals gaining near or greater than fifty percent of shareholder votes at companies such as Newell Brands, Starbucks and Duke Energy. Additionally, with increased shareholder concentration, particularly amongst the "Big Three" (Vanguard, BlackRock and State Street), the voting policies of these organizations have become particularly important, especially in regards to their approach to ESG-related issues.

SELECT CAMPAIGNS / DEVELOPMENTS

Company	Market Capitalization ($ in billions)[10]	Activist	Outcome
United Technologies	$97.9	Third Point / Pershing Square	• Pershing Square criticizes the company's announced merger with Raytheon after its planned spin-off of its Carrier and Otis business • Third Point also criticizes the deal, announcing it would vote against approval
EssilorLuxottica	$53.1	Investor group (7 investors)	• In the midst of a CEO succession dispute, Fidelity International, Baillie Gifford and five other investors nominate two directors to the company's board • Two dissident nominees fail to get elected
Sony	$54.8	Third Point	• Third Point calls on the company to focus on its entertainment business by spinning off its semiconductor business and selling its stakes in Sony Financial, M3, Olympus and Spotify
Occidental Petroleum	$44.0	Icahn Enterprises L.P.	• Icahn opposes the company's proposed acquisition of Anadarko and demands a shareholder vote on the deal • Icahn announces a proxy fight to replace four of the company's directors
Cerner	$20.4	Starboard	• No public activist campaign; Cerner announces settlement with Starboard—includes appointment of four new independent directors and Cerner committing to disclose buyback and margin targets, as well as establish a committee to oversee these initiatives
Groupe Renault	$18.8	CIAM	• CIAM sends letter to the company's board in opposition to proposed merger with Fiat Chrysler • Citing resistance from the French government Fiat Chrysler later withdraws merger offer
Ferguson	$13.0	Trian	• Trian takes 6% stake in Ferguson; announces it will engage management on a number of initiatives to create value
Aramark	$8.6	Mantle Ridge	• According to reports, Mantle Ridge considers forming consortium to mount a takeover of Aramark or otherwise push the company to explore a sale
Eagle Materials	$3.4	Sachem Head	• Eagle Materials refuses request from Sachem Head for board seat; Sachem Head nominates two directors to the company's board in response • Sachem Head withdraws director nominations after Eagle Materials announces it would separate its heavy and light materials businesses
Legg Mason	$3.1	Trian	• Legg Mason agrees to add Nelson Peltz and Ed Garden to its board, as well as a third independent director (despite no public push for change) • Legg Mason later announces plans to cut 12% of staff

[10] Market capitalization as of campaign announcement.

Corporate Governance

TRENDS[11]

In June 2019—following the busiest part of the 2019 U.S. proxy season—Institutional Shareholder Services (ISS) provided an early review of the U.S. proxy season vote results for 2019. As a part of the report, ISS reviewed the vote results for the 1,812 Russell 3000 annual general meetings that took place from January to May 2019 and identified the following major trends:

- **Increased Opposition to Director Elections.** Director elections faced the most significant levels of opposition since 2011 based on the number of director elections with support levels below 80% of votes cast. Between January and May of 2019, approximately 4.9% of directors up for election received support by less than 80% of votes cast, up relative to 4% in 2018 and significantly higher than the historical low of 2.9% for meetings over the same period in 2015. These numbers do not come close to the record highs for director opposition, which occurred in the wake of the U.S. financial crisis prior to the introduction of say-on-pay votes, where in 2009 9.4% of director election proposals received support from less than 80% of votes cast. However, for boards, the data is important because it evidences the trends we are seeing in what investors are focusing on with respect to board composition (in addition to company performance). Specifically, in addition to traditional factors such as board accountability, investors continue to emphasize (as well as refine) their views on factors such as board diversity (racial, gender and skillsets), board refreshment, director overboarding and board leadership. Additionally, for each of these factors investors have diverse viewpoints, highlighting again the importance for ongoing engagement by companies and boards with their shareholder base outside of the annual proxy season.

- **Environmental and social (E&S) shareholder proposals outnumber governance shareholder proposals for the third consecutive year in the United States.** While institutional investors and governance commentators trumpet the importance of companies to focus on ESG (environmental, social and governance) considerations, the 2019 proxy results show that the key area of focus of late is on environmental and social issues—such as political spend, climate change and sustainability—and less on traditional governance topics like majority voting and proxy access. This is not surprising, as many companies have already taken steps (either proactively or in response to shareholder pressure, or simply to align better with their peer groups) to adopt low-hanging fruit governance measures, or do so when a proposal is made in order to substantially implement the requested governance change. Accordingly, the 2019 proxy season saw the range of environmental and social issues continue to expand. Fifteen different E&S proposal categories accounted for more than 10 proposals each, with 62 political activity proposals and 45 board diversity proposals. Notably, one traditional governance proposal that continues to see a significant number of filings relates to independent chair (66 proposals).

- **E&S proposals receive record levels of support from investors.** The median support rate for E&S proposals reached a record high of 30% of votes cast, with 48% of voted E&S proposals receiving support above 30% of votes cast—as context, this figure did not exceed 10% of voted proposals until 2010. Notably, the gap between support levels for E&S proposals and governance proposals continues to narrow, with median support rates of 39% for governance proposals only 9% higher than median support rates for E&S proposals. This metric is important because historically investors have viewed E&S and governance proposals as distinct issues and were often reluctant to support E&S proposals that seemed to be disconnected from investment fundamentals. The advent of ESG integration has changed this view, and these voting trends indicate that investors are no longer viewing E&S and governance proposals as distinct issues, but are instead evaluating proposals on their merits in the context of the company and industry practice. However, influential institutional investors and other voices have characterized environmental and social considerations as inextricably linked to the long-term financial performance of companies, which can make it more difficult for companies to defeat these proposals unless they can demonstrate based on their specific circumstances why a particular initiative is not a matter of concern or would be overly difficult or costly to implement.

[11] Trend data from Institutional Shareholder Services (ISS) Analytics, *Early Review of 2019 US Proxy Season Vote Results* (June 2019) unless otherwise indicated.

- **E&S proposal withdrawal rates also reach record levels, reflecting the increased willingness of companies to engage with proponents to satisfy their requests.** Nearly 50% of E&S proposals were withdrawn so far in 2019—record level withdrawal rates that reflect the fact companies have become more willing to engage with E&S proponents to satisfy their requests related to environmental and social disclosures. In contrast, withdrawal rates for governance proposals are very low relative to historical levels. This is likely because, as stated earlier, many companies have already implemented low-hanging fruit governance changes, and governance proposals like the establishment of an independent chair or the ability of shareholders to call special meetings are not necessarily consensus items.

- **Say-on-pay proposals receive significant opposition.** From January through May 2019 say-on-pay proposals received one of the highest opposition rates since say-on-pay was introduced to U.S. ballots in 2011. In this context, investors are applying more rigor to their analysis of executive compensation programs, with many investors creating their own assessment models to identify problematic practices or misalignment between pay and performance. Areas of traditional focus for investors continue to be closely scrutinized, and include items such as disclosure of performance metrics and the rigor of incentive targets, as well as mega-grants or one-time special awards. However, in addition to these traditional areas of focus, investors are also paying close attention to a broad range of additional issues—including excessive emphasis on total shareholder returns (TSR), overcomplicated compensation programs that use too many metrics, or disclosure of compensation that executives expect to receive regardless of performance in a manner that makes it seem like performance pay. Again—given the range of investor viewpoints and evolving analysis by investors to evaluate say-on-pay—dialog with a company's shareholders on compensation considerations remains critical for boards of directors.

In addition to these overall trends, in a subsequent June 2019 report ISS published a review of newly appointed directors to identify trends in director nominations.[12] Based on its review of 19,791 directorships in the Russell 3000, the ISS report reveals the following trends:

- **Increase in board renewal rates continues.** As a growing number of investors have focused on board refreshment and board diversity, board renewal rates have increased in recent years. As of May 2019, 5.3% of ISS profiled Russell 3000 directors were new to their boards—down relative to the record high of 5.7% last year, but still the third highest rate in the period from 2008-2018. In addition, the percentage of companies introducing at least one new board member —35.6% through May 2019—was the highest percentage over that same period. The percentage of companies introducing at least two new directors declined relative to a 10-year high in 2018, but at a rate of 10.2% was also the third highest over the period from 2008-2018. This data supports the notion that companies are spending time on board self-evaluation and refreshment.

- **Gender diversity reaches record highs; ethnic diversity also reaches record highs, but has grown at a much slower pace.** Through May 2019, a record breaking 45% of new Russell 3000 board seats were filled by women, up from 34% in 2018. Currently, the number of board seats held by women is at an all-time high, with 27% of directorships now held by women in the S&P 500. This has been driven in part by recent institutional investor and proxy advisor policies targeting gender diversity, and as a result is a trend that is expected to continue. It has also been driven by new regulation, with states like California mandating board gender diversity (and other states also considering similar legislation). This year has also seen a record number of ethnic minorities joining boards as new members, with 21.1% of new directorships being filled by non-Caucasian nominees at S&P 500 companies, while approximately 15% of new board seats at all Russell 3000 companies were filled by minorities. However, while the trend towards increasing ethnic diversity on boards is upward, the rate of change is significantly slower relative to the trend in board gender diversity.

On the whole, the shift in the composition of corporate boards reflects broader market trends and investor expectations. As ISS notes, the view by investors, companies and regulators that greater diversity can improve long-term performance is reflected in these new director trends, particularly as investors emphasize the need for companies to focus on culture, sustainability and technology to remain competitive over the long run.

[12] Board diversity trends from Subodh Mishra, Institutional Investor Services, Inc., *U.S. Board Diversity Trends in 2019* (June 18, 2019) *available at* https://corpgov.law.harvard.edu/2019/06/18/u-s-board-diversity-trends-in-2019/.

CASES

From a Delaware case law perspective, Q2 2019 featured a notable case addressing the responsibility of directors to monitor critical compliance risks that face the corporation. In *Marchand v. Barnhill et. al.*, No. 533, 2018 (Del. June 19, 2019), the Delaware Supreme Court in a unanimous opinion reversed the Court of Chancery's dismissal of a stockholder derivative suit that alleged the board of directors and two officers of Blue Bell Creameries USA, Inc. ("Blue Bell") failed to provide adequate oversight of a critical risk area and as a result breached their duty of loyalty. The case arose due to serious contamination of ice cream made by Blue Bell, which resulted in widespread consumer illness, product recalls and ultimately three deaths. From the perspective of the duty to monitor as articulated in *Caremark*[13]—and despite the arduous standard for successfully pleading such a claim—the decision reemphasizes the importance of ensuring board-level information reporting systems. And for critical risks to the organization, the case highlights that Delaware courts will require more than compliance systems at the operational level—there must be a process to allow the board to be informed and monitor the performance of compliance programs that are mission critical. In this context, the court emphasized that central compliance risks are a board-level responsibility, and day-to-day operational safeguards, mere compliance with laws, and general reporting to the board on operational issues will not satisfy the board's duty to monitor risks that are mission critical. For these purposes, the case also highlights the importance of documentation. Boards should ensure compliance efforts and processes to evaluate compliance programs critical to the organization are well documented, and should also ensure review and discussion of central compliance efforts are appropriately documented in board minutes and other meeting materials.

POLICY

From a policy standpoint, the role of short-termism in our capital markets and the impact it has on Main Street investors and public company performance continues to be a major focus for regulators. In May 2019, Chairman Jay Clayton announced that the SEC staff would be hosting a roundtable—scheduled for July 18, 2019—to hear from investors, issuers and other market participants about the impact of short-termism on U.S. capital markets and whether the current reporting system, or other aspects of the SEC's current regulations, should be modified to address these concerns.[14] At the time of the announcement, Chairman Clayton directed the staff to consider four potential topics as they craft an agenda:

- The role, if any, that short-termism plays in the declining number of public companies, with a particular focus on how the pressure to take a short-term focus may discourage private companies from going public;
- The SEC's ability to reduce burdens for companies while facilitating better disclosure for long-term Main Street Investors, such as ways to streamline quarterly reporting obligations and exploring whether information typically included by companies in earnings releases could be allowed to satisfy these obligations;
- The potential for certain categories of reporting companies (*e.g.*, smaller reporting companies) to be given flexibility to determine the frequency of their periodic reporting; and
- Market practices geared towards longer-term thinking and investment at public companies.[15]

In early July the SEC released the agenda for the roundtable, which will consist of two panels. The first panel will focus on the impact of a short-term focus on U.S. capital markets, where the panel will, "explore the causes and impact of a short-term focus on our capital markets, and seek to identify potential market practices and regulatory changes that could encourage long-term thinking and investment."[16] The second panel will focus on the SEC's current reporting system's role in fostering a long-term focus and will, "discuss what specific regulatory changes to that system could be implemented to foster a longer-term focus" in the SEC's periodic reporting system.[17]

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[13] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

[14] Chairman Jay Clayton, Statement Announcing SEC Staff Roundtable on Short-Term / Long-Term Management of Public Companies, Our Periodic Reporting System and Regulatory Requirements (May 20, 2019) *available at* https://www.sec.gov/news/public-statement/clayton-announcement-short-long-term-management-roundtable.

[15] *Id.*

[16] Press Release, Securities and Exchange Commission, SEC Staff to Host July 2018 Roundtable on Short-Term / Long-Term Management of Public Companies, Our Periodic Reporting System and Regulatory Requirements (July 2, 2019) *available at* https://www.sec.gov/news/press-release/2019-117 (announcing the agenda for the roundtable).

[17] *Id.*

In addition to the SEC's announced roundtable to evaluate the impact of short-termism on our capital markets, the SEC also published its Spring 2019 Regulatory Flexibility Agenda ("RegFlex Agenda"), which reflects the priorities of the Chairman of the SEC and includes a short-term agenda of rulemaking that the SEC expects to address in the upcoming year. Of the numerous items included, notable items for corporate governance on the short-term agenda include proposing:

- Rule 14a-8 amendments regarding the threshold levels for shareholder proposals;
- Rule amendments to address the reliance by certain advisors on the proxy solicitation exemptions in Rule 14a-2(b), which commentators suggest is targeting the ability of proxy advisory firms to rely on the Rule 14a-2(b)(3) exemption to the proxy solicitation rules; and
- Rule amendments to modernize and simplify disclosures regarding Management's Discussion & Analysis (MD&A), Selected Financial Data and Supplementary Financial Information.

In addition to the short-term items, the RegFlex Agenda also includes a long-term section with a number of corporate governance items as well. These are not high priority matters for the Chairman of the SEC, and given the SEC's limited resources, we do not expect to see developments on these items over the upcoming year. But still, corporate governance items to keep an eye on for the future include:

- Pay-versus-performance disclosures;
- Universal proxy;
- Form 10-K summary;
- Corporate board diversity disclosures;
- Simplification of disclosure requirements for emerging growth companies and forward incorporation by reference on Form S-1 for smaller reporting companies;
- conflict minerals amendments;
- proxy process amendments (related to proxy plumbing issues); and
- earnings releases / quarterly reports (*i.e.*, streamlining the reporting process).

The agenda items are in various stages of the rulemaking process, and as is customary the SEC did not provide additional guidance on the agenda. But corporate governance professionals will be watching to see progress against these rulemaking initiatives, particularly given Chairman Clayton's emphasis on streamlining the agenda to include priority initiatives the SEC can effectively undertake.

THE LONG VIEW ON SHAREHOLDER EXPECTATIONS

The second quarter of 2019 continued to see commentary from institutional investors regarding environmental, social and governance (ESG) issues as institutional investors continue to refine their approach to assessing ESG factors in the context of long-term financial performance. Importantly, boards must understand that for investors ESG is now viewed as a critical component to sustainable investing and not just based on individual investor views on particular social issues. For example, Vanguard's April 2019 Investment Stewardship Commentary notes:

- "'Long-term investing' and 'sustainable investing' are synonymous."
- "We consistently engage with portfolio companies about climate risk. . . . We believe that climate risk can potentially have a long-term impact on companies in many sectors. But our discussions on these issues are anchored to a broader conversation about governance, in particular how a company's strategy and the related risks are governed by its board."
- "By advocating for policies and practices that support sustainable value creation over the long term, we believe we are giving our clients—and all investors—their best chance for investment success." [18]

In this context, investors are continuing to refine their approach to evaluating material ESG factors that relate to sustainable investing and long-term financial performance. For example, State Street Global Advisors has developed a scoring system that utilizes multiple data sources and aligns them with widely accepted, transparent materiality frameworks to generate a unique ESG score (which State Street has termed an "R-Factor").[19] State Street's R-Factor utilizes the materiality framework of the Sustainability Accounting

[18] Vanguard, *What we do. How we do it. Why it matters. Vanguard Investment Stewardship Commentary* (April 2019) *available at* https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf.

[18] Rakhi Kumar, State Street Global Advisors, *Putting Companies in the Driver's Seat to Enhance ESG Reporting* (May 8, 2019) *available at* https://corpgov.law.harvard.edu/2019/05/08/putting-companies-in-the-drivers-seat-to-enhance-esg-reporting/.

Standards Board (SASB), as well as market-specific corporate governance codes, and is designed to make it easier for investors to evaluate ESG factors and for companies to understand and provide meaningful ESG disclosures.[20] Importantly, as investors continue to refine their approach to ESG investing, companies should expect to gain greater clarity regarding the adequacy of their ESG disclosures and items that are material to long-term investors. However, at the same time, boards can also expect that as evaluation and communication of ESG factors becomes more transparent, investors will be less accepting of failures to provide disclosure on ESG issues that are important to their investment framework.

[20] *Id.*