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# SHAREHOLDER CONSIDERATIONS IN PUBLIC MERGERS AND ACQUISITIONS IN THE CONTEXT OF INCREASED OWNERSHIP CONCENTRATION AND INSTITUTIONAL INVESTOR STEWARDSHIP

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*By Alexander Georgieff * / ** / ****

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## I. Introduction

In our recently published article "Key Drivers of Global Mergers & Acquisitions since the Financial Crisis", my co-author and I observed that during the current mergers and acquisitions ("M&A") cycle, corporate boards have shown greater strategic and financial discipline when pursuing acquisitions than during preceding periods.[1] However, we also noted that towards the end of this current cycle, acquirers have on average based their bids on more optimistic financial assumptions. They have projected higher achievable synergies than before and offered to share these synergies more generously with the shareholders of already highly valued target companies in the form of bid premia, while still expecting their transactions to create value.[2] Notwithstanding, bidders were frequently rewarded with an increase of the price of their own company's shares, when their shareholders perceived an acquisition as the right choice, both strategically (versus other external or internal growth generating investment opportunities) and financially (versus other value creating alternatives, including share buy-backs, or no deal at all).[3] Yet, the current M&A cycle may have passed its peak as public equity markets have become more volatile, valuation multiples have come under pressure and the leveraged loan market has shown signs of overheating.[4] The resulting increase of operating and market risks is likely to have a dampening effect on shareholders' enthusiasm for acquisitions, especially those that are highly priced, unlikely to be accretive in the short term or the foreseeable future and/or financially stretched[5], such as the recent acquisition of Monsanto by Bayer (please refer to the Appendix for a detailed transaction summary and discussion).[6]

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[1] A. Georgieff/F. Bretag, *Key Drivers of Global Mergers & Acquisitions since the Financial Crisis*, Institute for Law and Finance, Working Paper No. 155 (2019), p. 21.

[2] Id., p. 22.

[3] Id.; Boston Consulting Group, Inc., *The 2018 M&A Report: Synergies Take Center Stage*, 12 September 2018, pp. 4 and 10, www.bcg.com.

[4] Id., pp. 2-4.

[5] "Empirical studies of acquisitions consistently find that public company bidders often overpay for targets, imposing significant losses on bidder shareholders. Numerous studies have connected bidder overpayment with managerial agency costs and behavioral biases that reflect management self-interest." A. Afsharipour/J.T. Laster, *Enhanced Scrutiny on the Buy-Side*, 53 Georgia Law Review 443 (2018).

[6] Bayer's acquisition of Monsanto may be remembered as one of the most value destroying acquisitions in recent history, eclipsing another unsuccessful transaction involving a German company and a US company, the merger of Daimler and Chrysler in 1998 (which was effectively a takeover by Daimler). The Monsanto deal has been criticised as strategically flawed, too expensive, too aggressively financed and for insufficient due diligence and risk evaluation. Financial Times, *Bayer's €50 billion blunder*, 7 August 2019, www.ft.com.

In this context, it is important to note that the shareholder structure of many public companies in the developed equity markets has changed quite significantly in recent years, resulting in a subtle shift of power away from boards to influential shareholders. A relatively small number of shareholders with large shareholdings in many public companies and proxy advisors have gained considerable influence on the outcome of shareholder votes and tender offers.[7] They may take a much stronger interest in issues of corporate strategy and governance, including the critical evaluation of M&A proposals. Importantly, activist shareholders are now more frequently seen to also oppose M&A transactions.[8] In the US, lawsuits in which shareholders allege breaches of target company directors' fiduciary duties in the context of an offer for, or the sale of, a public company, are by now very common.[9]

Although boards continue to be primarily responsible for the formulation and implementation of corporate strategy, including M&A, shareholders have become increasingly more active and engaged. Hence, boards need to carefully consider the views of their shareholders when planning an important transaction. They must do so not only as a matter of corporate law and governance, but also for practical purposes. Even where shareholder approval is not required for the completion or the funding of a transaction, shareholders may vote to remove managers (or put pressure on supervisory boards to not renew their contracts) if they perceive that they have not acted in their best interest, initiate lawsuits against them or simply sell their shares.

This article seeks to explore relevant shareholder considerations in relation to public M&A transactions. It rests on the key assumption that shareholders expect management to run a company profitably, to optimise the value of their shares and hence to avoid value destroying transactions. For this purpose, it will summarise the history and key objectives of important public takeover laws, describe the different types of public company shareholders and their objectives, illustrate the different sources of value generation (including M&A), (which shareholders expect management to identify and to exploit, and which may complement but also compete with each other), and review commonly applied analytical approaches to the evaluation of the financial effects, in particular returns, associated with public M&A transactions. Finally, it will also discuss the limited

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[7] Chapter V.

[8] Chapter VII. 5.

[9] "Slowly at first, and then at an accelerating place, the volume of stockholder-led, sell-side M&A litigation increased. During the first decade of the 21st century, it became an epidemic, with sell-side challenges to over 90% of all takeovers in excess of $100 million", A. Afsharipour/ J. T. Laster, supra note 5, referring to M. D. Cain/S. Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 Iowa Law Review 465, 475 (2015) and O. Koumrian, *Shareholder Litigation Involving Acquisitions of Public Companies*, Review of 2014 M&A Litigation, Cornerstone Research 1 (2015).

circumstances in which shareholder approval must be sought by the acquiring company’s management before it can proceed with a material acquisition, including the proposed acquisition of a public company, with reference to the current legal frameworks and/or listing rules in the United States (“US”), the United Kingdom (“UK”) and Germany, and weigh their respective pros and cons.

## II. Public M&A related rules and regulations

The securities, corporate and takeover laws are concerned with the protection of shareholders and their interests. They were either amended, further developed or new statutes were enacted to achieve this objective also in the context of public mergers and acquisitions.

### 1. History

#### *a) United States*

Corporate takeover battles did not occur in the US until twenty years after the passage of the federal securities laws in 1933 and 1934.[10] In 1968, Congress passed the Williams Act[11], which amended the Securities Exchange Act of 1934 in several key respects. The overall objective of the new rules was to prevent bidders from conducting "Saturday night special" tender offers, i.e. offers that put pressure on shareholders to tender their shares by demanding a rapid decision and making the offer available on a first come, first served basis. Instead, shareholders were given time to decide so they would not be penalised for being the last to tender.[12] In addition, important rules concerning the conduct of board directors during the course of a public takeover were established by case law, in particular in a series of landmark judgements by the Delaware Supreme Court in the mid-eighties.[13]

#### *b) United Kingdom*

As in the US, the history of hostile takeovers in the UK began in the early 1950s. The first wave of hostile takeovers was fuelled by arbitrage opportunities resulting from the "economic upheavals of the post-war period", such as undervalued assets on the balance sheets of companies in an otherwise

[10] R. Chernow, *The House of Morgan: An American Banking Dynasty and The Rise of Modern Finance* (1990), pp. 508-511; "... (t)he so-called American model of transparent financial markets and shareholder democracy didn't just arise spontaneously in the marketplace but rather represented, at least in part, a political reaction to market forces. ... Wall Street bankers had long insulated management from shareholder pressure by enforcing a taboo on hostile takeovers. They were the fiercely protective gatekeepers who kept out the barbarian hordes ... an unintentional by-product of the system of exclusive client relations (under the Gentleman Banker's Code)." R. Chernow, *The Death of the Banker: The Decline and Fall of the Great Financial Dynasties and The Triumph of the Small Investor*, First Edition (1997), pp. 52, 66, 67.

[11] The Williams Act of 1968 amended the Securities and Exchange Act of 1934, 15 U.S.C.A. §78a et seq., to require mandatory disclosure of information regarding tender offers.

[12] J. Armour/D. Skeel, *Who Writes the Rules for Hostile Takeovers, and Why?* The Peculiar Divergence of US and UK Takeover Regulation, 95 The Georgetown Law Journal 1727, 1754- 1755 (2007).

[13] Chapter VII. 1., infra notes 92-94, 106-111.

inflationary economic environment.[14] Target company boards, in the absence of restrictive rules, adopted defensive measures without asking their shareholders. On the initiative of the Bank of England, and to pre-empt legislative action, a committee comprised of institutional investors, merchant banks, commercial banks and the London Stock Exchange devised a code of conduct to regulate takeover bids. It was intended to primarily safeguard the interests of shareholders and established some key principles, including that shareholders must decide for themselves whether to sell and that the target company board was to remain neutral in the event of a takeover bid. The initial code of conduct was replaced by the Code on Takeovers and Mergers ("Takeover Code"), which was finalised in March 1968. It consisted initially of ten general and thirty-five specific rules. The basic principle of shareholder choice (taken from the initial code of conduct) was supplemented by a general ban on frustrating actions.[15]

*c) Germany*

Prior to the passage of the German Takeover Act in 2002, there was no legislation in Germany relating to the acquisition of shares by way of a public bid. Instead, the only previously existing rules were contained in a voluntary takeover code ("German Takeover Code"), which the Federal Ministry of Finance had issued in 1995, but which was binding only on companies who had acceded to it.[16] The German Takeover Code was largely modelled after its UK namesake and also contained a mandatory bid rule as well as a prohibition on frustrating action. However, it was considered unsuccessful because many large and important German listed companies chose not to abide by its rules. A first legislative effort in 1997 to replace the German Takeover Code with a takeover statute was rejected in the German parliament; it had been made in the aftermath of a hostile takeover attempt by steel producer Krupp for its larger rival Thyssen, which was heavily opposed by politicians from all parties and resulted eventually in a politically engineered friendly merger of the two companies.[17] Capital market reforms introduced by the Schröder government (1998-2005) were widely expected to also include a takeover friendly legal regime[17a], but the

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[14] "As in the United States, much of the British business community was initially outraged by the advent of the takeover bid and believed that takeovers were harmful for industry." J. Armour/D. Skeel, supra note 11, pp. 1756-1757; "Most City men continued to disapprove of take-overs, believing that the directors of a company knew what was in the best interest of the shareholders and the workforce better than marauding financiers motivated by profit … Yet a few, such as Lionel Fraser and Siegmund Warburg … held the view that the owner that put the highest valuation on assets was most likely to manage them most efficiently." R. Roberts, *Schroders: Merchants and Bankers* (1992), p. 407.

[15] J. Armour/D. Skeel, supra note 12, pp. 1759-1760.

[16] S. Schuster/C. Zschocke, *Übernahmerecht/Takeover Law* (Frankfurt am Main, 1996, Supplement March 1998); ZIP 1995, 1464.

[17] Entwurf eines Gesetzes zur Regelung von Unternehmensübernahmen (Übernahmegesetz), Deutscher Bundestag, Drucksache 13/8164, 2 July 1997; J. Adolff et al., Public Company Takeovers in Germany (2002), p. 105.

[17a] A. Georgieff/R. Weber, Fairness Opinions, Studien des Deutschen Aktieninstituts, Heft 52 (2012), p. 12.

takeover of German industrial conglomerate and operator of a pan-European mobile phone network Mannesmann in 2000 by its competitor Vodafone (to this date still the largest corporate takeover in history with a transaction value of €178 billion/$203 billion) changed the sentiment amongst lawmakers who approved a revised draft of a German Takeover Act, which included important exemptions to the prohibition on frustrating action.[18]

*d) European Union*

The European Union (“EU”) Takeover Directive came into effect on 20 May 2004 and required that all member states pass legislation to implement it within two years, by 20 May 2006.[19] By harmonising member states' national takeover laws with the goal of achieving uniformity and a level playing field across the EU, it was intended as an important step towards a free and single European market for goods and capital, in accordance with the legislative objectives of the Single European Act of 1986.[20] The Directive reflects the "Commission's ambition to change Europe's regulatory regime from a traditionally restrictive takeover regime to a more pro-investor, takeover-friendly system driven by natural market forces".[21] It is therefore not surprising that it "adopted many of the structural elements of the City Code including a mandatory offer rule and, in its original version, a strict prohibition on frustrating action".[22] However, its final version represents a political compromise. It allowed member states to apply ("opt-in") or dis-apply ("opt-out") Art. 9 on takeover defences ("neutrality" rule) and Art. 11 on multiple voting rights ("break-through" rule) in the course of transforming the Directive into national law.[23]

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[18] Entwurf eines Gesetzes zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und von Unternehmensübernahmen, Deutscher Bundestag, Drucksache 14/7034, 5 October 2001; J. Adolff, id., p. 107;

Just as legislators were moving towards replacing the voluntary takeover code with a binding statutory takeover regime, INA-Holding Schäffler (“Schäffler”) created headlines with an audacious hostile bid for its competitor FAG Kugelfischer AG. Within only a few years, with the new Takeover Act in effect, Schäffler launched another hostile takeover when it bid for car supplier Continental in the summer of 2008. Even though the transaction was governed by the rules of the Takeover Act, it was highly controversial. Many observers perceived Schäffler's tactics, which exploited the statutory minimum price rule for its "low ball" offer and a loophole in the laws relating to the disclosure of significant shareholdings for the secret accumulation of a significant direct and indirect stake prior to its offer, as aggressive and opportunistic. In the end, Schäffler’s bid for Continental succeeded but almost bankrupted the company, since the Takeover Act required its offer to remain open despite the intervening market crash in October 2008. The disclosure rules of the German Securities Trading Act were subsequently amended.

[19] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, Official Journal of the European Union L 142/12.

[20] D. Tuchinsky, *The Takeover Directive and Inspire Art: Re-evaluating the European Union’s Market for Corporate Control in the New Millenium*, 51 New York Law School Law Review 689, 697 (2006/2007).

[21] Id., p. 691.

[22] J. Adolff et al., supra note 17, p. 106.

[23] D. Tuchinsky, supra note 20, p. 692.

Germany opted out of the strict no frustrating action rule[24] by codifying three exceptions to the general prohibition of frustrating action, namely (i) the going concern exception; (ii) the white knight exception; and (iii) the supervisory board exception, which allows the management board to take any defensive action against a takeover bid with the prior consent of the supervisory board, provided it falls into its sphere of competence and does not violate other legal rules.[25]

## 2. Regulatory objectives

*The bidder's conduct* is regulated by rules contained in securities and takeover laws.[26] They seek to prevent bidder coercion of target shareholders by providing them with disclosure sufficient to make an informed investment decision; sufficient time in which to make that decision; and require equal, or equivalent, treatment of shareholders of the same class. EU takeover laws also contain rules on mandatory offers, the minimum offer price, secure funding of the offer, maximum time limits and on frustrating actions, which are subject to limitations.

Special rules apply to *target directors' conduct* before and during a takeover, in order to mitigate or resolve conflicts of interest between directors (management) and shareholders: In the US, these rules are contained in state law (mostly case law)[27]; in the EU, takeover laws regulate also target board directors' conduct during an offer, whereas general corporate law applies before the application of a takeover law is triggered.[28]

[24] J. Adolff et al., supra note 17, pp. 106-107.

[25] Article 12 No. 1 EU Takeover Directive; Section 33 Para. 1 German Takeover Act.

[26] e.g. §§13(d), 14 (d) Securities Exchange Act ("Williams Act"), The UK Takeover Code, German Takeover Act

[27] Chapter VII. 1.

[28] Rule 21.1 UK Takeover Code provides that "during the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, the board must not, without the approval of the shareholders in general meeting" take any frustrating action. In contrast, section 10 of the German Takeover Act defines the publication of the decision to make a public offer as the principal reference point. Please also refer to Article 9 No. 2 Para.2 European Takeover Directive.

## III. Public company shareholders

So, who are the shareholders and what are their interests, which the law seeks to protect?

Public company shareholders, and the shareholder structure of a public company, are often quite different from shareholders and/or the shareholder structure of a private company. Typically, a private company will have only few shareholders whereas a public company may have many. A private company's shareholders often include the founder(s), and his/their family/families and/or private equity investors. Their rights and obligations follow from the company's articles of incorporation, bylaws, shareholder agreement(s) and applicable corporate laws. These investors can sell some or all of their shares, either privately or in the context of a company's initial public offering of shares ("IPO") (when they are bought by new investors).

During and after an IPO, the shareholder structure of a company changes. It will thereafter often comprise domestic and foreign investors, strategic and financial investors, active and passive investors, short-term and long-term investors. When they receive a public offer for their shares, they will enjoy the additional protection of the applicable public takeover laws.[29]

In the following paragraphs, the different types of public company shareholders will be explained with reference to the DAX 30 index ("DAX 30"), whose constituent companies are the thirty most valuable German companies (by the market value of their free float, i.e. shares that are widely held).[30] The relevant data were obtained from a relatively recent study by DIRK and IPREO.[31]

### 1. Predominance of Anglo-Saxon shareholders

A vast majority (84.1%) of DAX 30 shareholders are foreign investors. As of the date of the IPREO study, approximately 54% of shareholders were Anglo-Saxon investors (33.5% from North America, 20.4% from the UK and Ireland). This is significant and explains to a large extent the adoption of market practices and usances in the German (and other national) equity market(s), which were originally developed in the US or in the UK. The largest institutional shareholders were

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[29] Chapter II.

[30] www.boerse.de (DAX-Trading Grundlagen, Erklärung DAX, MDAX und TecDAX).

[31] *Investoren der Deutschland AG 5.0: Die Aktionärsstruktur des deutschen Leitindex DAX 30.* Eine Gemeinschaftsstudie von IPREO Ltd. und Deutscher Investor Relations Verband (DIRK), June 2018; please also refer to J. Seldeslachts/M. Newham/A. Banal-Estanol, *Changes in common ownership of German companies*, DIW Economic Bulletin 30.2017, pp. 303-314; and K. Fehre/M. Rapp/B. Schwetzler/M. Sperling, *The disappearing 'Deutschland AG' – an analysis of blockholdings in German large caps*, Problems and Perspectives in Management, Volume 9, Issue 4 (2011), pp. 46-58.

also, with only very few exceptions, Anglo-Saxon. They invest globally, in many different international equity markets, to diversify their equity portfolios. These investors expect the same or at least similar rules concerning disclosure and governance to apply to all the companies they are invested in and the securities these companies have issued, irrespective of a company's legal domicile or primary market.

## 2. Strategic shareholders

A small number of mostly non-financial, domestic shareholders own significant shareholdings and can strongly influence some of Germany's largest companies. Collectively, as of the date of the IPREO study, they held approximately 18% of the equity capital of all DAX 30 companies combined. These investors include shareholders with either a majority shareholding or a so-called blocking minority, i.e. the ability to prevent important corporate resolutions at a company's shareholders meeting, in eleven DAX 30 companies. This type of shareholder is referred to as "strategic investor". Strategic investors comprise founders and/or their families and descendants, corporate investors and government entities.

## 3. Shareholders with primarily financial interests

The remaining 82% of shareholders in DAX 30 companies pursue primarily financial interests. Previously, their shareholdings rarely exceeded the applicable initial disclosure thresholds (in most jurisdictions either 3%, e.g. in Germany, or 5%), but this has changed (as will be discussed in chapter V. below). The term "financial investor" refers to entities that pool together the assets of many individual investors. They are typically organised as investment funds, operated by investment managers, and include exchange traded funds ("ETF"), both open-end and closed-end mutual funds, and hedge funds.[32]

Sovereign wealth funds are funded by sovereign states and pursue strategic and/or financial interests.

[32] L. Bebchuk/A. Cohen/S. Hirst, *The Agency Problems of Institutional Investors*, Harvard Law School Program on Corporate Governance, Discussion Paper No. 930 (08/2017), 31 Journal of Economic Perspectives 89, 94 (2017).

## 4. “Active” and “passive” shareholders

Most institutional public equity investors hold their investments for long periods, often for many years. This is especially true for so-called passive investors. These investors replicate an equity index, either physically or synthetically, and only adjust their investment in a company's shares periodically to reflect the company's actual weighting in the relevant index.[33] When an index constituent company's shares are excluded from the index, a passive investor must sell its entire shareholding. Passive managers have committed considerable resources to proxy voting and corporate governance and play an increasingly important role as "power brokers" in proxy or takeover battles.[34]

Active investors, on the other hand, actively manage their investments and portfolios. They seek to outperform their investment benchmarks (typically indices) by picking stocks, which they expect to outperform, and by avoiding stocks, which they believe will underperform.[35] This requires strong investment skills, in particular thorough market research. Active managers may also invest in a company in the expectation of industry consolidation and resulting M&A. They will closely review the financial implications of any M&A proposal and act in accordance with their assessment. It is not uncommon for active investors to sell shares of a target company upon the announcement of a transaction, especially when the share price rises close to the offer price. In these situations, they may be willing to trade the remaining price difference for certainty and the ability to immediately re-invest the sale proceeds.

## 5. Activist shareholders

Activist investors are a special type of active investor. They combine active investing, trading and M&A execution skills (and possibly also financial leverage) to pursue superior investment returns. An activist investor may obtain or attempt to obtain representation of the company's board of directors in an effort to impact the firm's policies or strategic direction and in some cases may advocate activities such as division or asset sales, partial or complete corporate divestiture, dividend

[33] *Passive Investing, Index Investing,* Investopedia, www.investopedia.com.

[34] *Meet the New Corporate Power Brokers: Passive Investors*, The Wall Street Journal, 24 October 2016, www.wsj.com.

[35] *Active vs. Passive Investing: What’s the Difference,* Investopedia, www.investopedia.com.

or share buybacks, and changes in management. M&A related activism is an important and increasingly frequent objective of activist campaigns.[36]

Activist campaigns have seen a strong resurgence since the financial crisis and activist funds have enjoyed high inflows. The number of campaigns has risen by 50% between 2013 and 2018 (Figure 1). The strategy is most prominent within the US, and the vast majority of known institutional investors in activist funds are based in North America.[37] However, it is a strategy that is now also frequently applied outside the US, especially in Europe. The increased size of activist funds and their successes have created a "virtuous" circle that has allowed activist investors to target larger corporations in which to invest.[38]

Activist investors are frequently criticised for their short-term focus and investment horizon, which would keep companies from pursuing investments in capital equipment, innovation and human capital.[39] Their supporters argue that "activists fill a governance void that afflicts today's public companies".[40]

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[36] An activist investor is "an individual or group that purchases ... a public company's shares and/or tries to obtain seats on the company's board with the goal of effecting a major change in the company. A company can become a target...if it...has a problem that the activist investor believes it can fix to make the company more valuable." Investopedia, www.investopedia.com.

For further definitions of "shareholder activist or activism: "Activist", HFR Hedge Fund Strategy Definitions – Event Driven, www.hedgefundresearch.com; or *Shareholder Activist Definition*, Investopedia, www.investopedia.com.

A. Georgieff/F. Bretag, supra note 1, p. 18; S. Chen/E. Feldman, *Activist-Impelled Divestitures and Shareholder Value,* 39 Strategic Management Journal 2726-2744 (2018).

[37] *Capitalism's unlikely heroes,* in The Economist, 7-13 February 2015; D. Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 Virginia Law & Business Review, 459 (2013).

[38] The world's largest companies by market capitalisation are now within the reach of activist investors. This is illustrated by Carl Icahn's investment in Apple (2016-2018) and Third Point's current investment in Nestle, which were/are at the time of these investments the most valuable US and European company, respectively. See also H. Bader/A. Georgieff, *Shareholder Activism in Germany: Similar but different,* International Bar Association, Corporate and M&A Law Committee newsletter article, June 2015, p.1.

[39] M. Lipton, *The Threat to the Economy and Society from Activism and Short-Termism Updated,* The Harvard Law School Forum on Corporate Governance and Financial Regulation, 27 January 2015, www.corpgov.law.harv.edu.

[40] *Capitalism's unlikely heroes*, supra note 37; L. Bebchuk/A. Brav/W. Jiang, *The Long-Term Effects of Hedge Fund Activism,* 115 Columbia Law Review (2015); D. Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence,* 7 Virginia Law & Business Review 459 (2013)

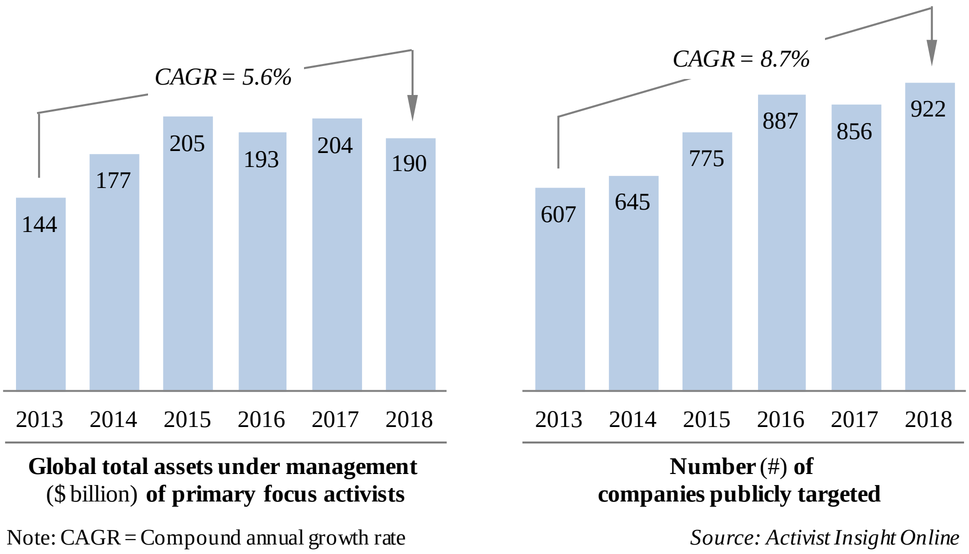


*Figure 1: The growing influence of activist investors*

## 6. Merger arbitrageurs

The most active - but also most short term - investors are traders who increasingly rely on artificial intelligence and frequently employ algorithm based trading programmes. Depending on their mandate, they may also leverage their investments to boost returns (but also risk). Merger arbitrageurs employ an investment process primarily focused on trading opportunities in equity and equity related instruments of companies which are engaged in a corporate transaction. They take a view on transaction closing risk and seek to capitalise on the spread between the offer and the trading price of a target company's shares.[41] In most instances, arbitrageurs will be positioned to benefit from a successful offer and will vote accordingly. It is not uncommon for arbitrageurs to accumulate significant shareholdings in a target company during the disclosure-relevant time window (e.g. four plus two working days in Germany, ten working days in the US).[42]

## 7. Proxy advisors

A proxy advisory firm is not a shareholder, but it influences the voting decisions of its clients. Its advice is sought by institutional investors, including index funds with shareholdings in a very large

[41] H. Bader/A. Georgieff, supra note 38, p. 4.

[42] In the US, under federal securities law, when a person or group acquires more than 5% of any class of a company’s shares, this has to be disclosed after 10 days on Schedule 13 D, in accordance with §13(d) of the Securities and Exchange Act. In Germany, the person or group subject to the duty of disclosure must declare the crossing of relevant ownership thresholds promptly but in any case no later than four working days after it obtained knowledge of this fact, which is presumed to have occurred at the latest two days after the event, §33 para. 1, s.1 and s.3 Securities Trading Act.

number of companies each. Proxy advisors analyse proposals to shareholders and make voting recommendations to their clients. They are frequently commissioned to vote the shares of their clients at shareholder meetings. The votes executed are called "proxy votes" because the shareholder usually does not attend the meeting and instead sends instructions to a third party, or proxy advisor, to vote his shares in accordance with the instructions given on a voting (proxy) card.[43] The influence of the two leading proxy firms, in particular, ISS and Glass Lewis & Co, is considerable.[44] “(P)owerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills. They do so because the CEOs recognize that some institutional investors will simply follow ISS’s advice rather than do any thinking of their own. ISS has been so successful that it now has a California rival, Glass Lewis.”[45] In Europe, proxy advisory services are also offered by non-US firms such as Ethos.[46] However, more recently, large institutional investors have come under pressure to reverse the trend towards outsourcing the analysis of shareholder proposals and to focus instead on making voting decisions in their clients’ best interests and in accordance with their own (rather than a proxy advisor’s) proxy voting policies and procedures.[47] Proxy firms have also been criticised for their limited transparency and accountability, lack of competition (given ISS’s dominant role), potential conflicts of interest and largely unregulated status, which has triggered a review by the US Securities and Exchange Commission (“SEC”).[48] This criticism was addressed in the SEC’s recently published Guidance[49], over which ISS has sued the SEC (“… to prevent the chill of proxy advisers’ protected speech and to ensure the timeliness and independence of the advice that shareholders rely on to make decisions with regards to their portfolio companies”).[50]

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[43] A. Tuch, *Proxy Advisor Influence in a Comparative Light*, 99 Boston University Law Review 1459, 1464 (2019); S. Choi/J. Fisch/M. Kahan, *The Power of Proxy Advisors: Myth or Reality?* 59 Emory Law Journal 869, 870-871 (2010).

[44] S. Choi et al, id., pp. 871-872.

[45] L. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face,* 30 Delaware Journal of Corporate Law 673, 688 (2005).

[46] www.ethosfund.ch

[47] D. Katz/S. Niles/E. Tetelbaum (Wachtel, Lipton, Rosen & Katz*), Institutional Investors’ Proxy Voting Responsibilities and Use of Proxy Advisory Firms*, Harvard Law School Forum on Corporate Governance and Financial Regulation, 22 August 2019, www.corpgov.law.harvard.edu

[48] T. Doyle, *The Conflicted Role of Proxy Advisors, American Council for Capital Formation* (22 May 2018); S. Choi et al., p. 872. In 2018, the Securities and Exchange Commission (“SEC”) withdrew two no-action letters to ISS and Egan-Jones, respectively, which were interpreted to protect certain institutional investors from liability for fiduciary breach if they relied on the services of proxy advisors. More recently, in August 2019, the SEC published New Guidance on Investment Advisors’ Proxy Voting Responsibilities and Reliance on Proxy Advisors, Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisors, SEC 17 CFR Parts 271 and 276, Release Nos. IA-5325; IC-33605.

[49] Id.

[50] ISS’s CEO Gary Retelny, 31 October 2019) www.issgovernance.com; *Proxy Adviser ISS sues U.S. market regulator over guidance aimed at curbing advice*, 31 October 2019, www.reuters.com.

The leading proxy firms have issued voting guidelines which also cover M&A related shareholder proposals.[51]

[51] BlackRock, BlackRock Investment Stewardship, Global Corporate Governance Guidelines & Engagement Principles, January 2019, p.6; Vanguard, Proxy voting guidelines for U.S. portfolio companies, effective April 1, 2019, pp. 9-10.

## IV. Public company shareholder objectives

Since shareholders are the beneficiaries of a company's net financial results and decide on the composition of its board (the supervisory board in jurisdictions with a two tier board system), it is critical for board directors to understand their key objectives and concerns. This is especially relevant in the context of important corporate transactions, in particular public M&A.

### 1. Strategic objectives

Strategic investors seek to monitor and influence - sometimes even control - corporate strategy and decisions; financial investors less frequently so. Strategic investors are typically represented in a company's board and often nominate the chairperson. They will want to retain their influence and hence be concerned by any transactions (share issuance, M&A) that may lead to a dilution of their ownership interest and associated governance rights.

Some strategic investors will manage their shareholdings more actively than others. They may wish to acquire absolute control of a company by taking it private, which can create conflicts with a target board and fellow shareholders.[52] Conversely, when they lose their strategic influence they may attempt to put the company "in play" in order to obtain a higher price, including a bid premium, for their shareholding (and, by implication, for all the other shareholders).[53]

Most strategic investors typically pursue their interests over longer time periods, sometimes over several generations. Some financial investors also take a long-term "hold" approach, others don't.

Occasionally, investments which were initially meant to be of a purely financial nature may become strategic, or financial investment strategies become more focused on fewer, sizeable investments with the ability to influence corporate governance.

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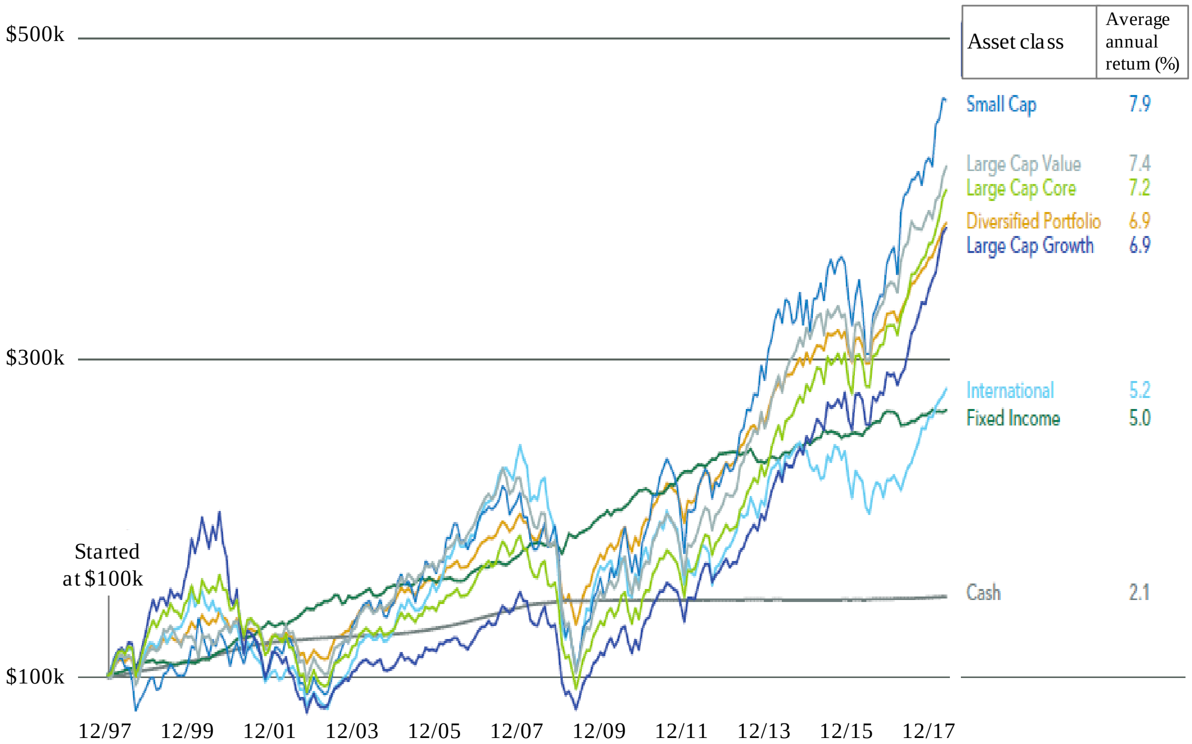
[52] When directors stand on both sides of a transaction and, thus, have a conflict of interest between the fiduciary duty (duty of loyalty) they owe to a corporation (and its shareholders) and their own financial interest, "they bear the burden of proof of establishing the *entire fairness* of the transaction". Sterling v. Mayflower Hotel Corp., 89 A.2d 107, 110 (Del. 1952); please also refer to chapter VII. 1., infra notes 100-105.

[53] Chapter VII. 4.c)

## 2. Financial objectives

Both strategic and financial investors are presumed to pursue financial interests. They expect the value of their investments to increase (or at a minimum to be preserved). Public equity investors want to achieve returns on their investments which exceed those from other asset classes to compensate for the higher risk and volatility associated with equity investments.




*Source: BlackRock*

*Figure 2: Growth of a hypothetical $100.000 investment (1998-2017)*

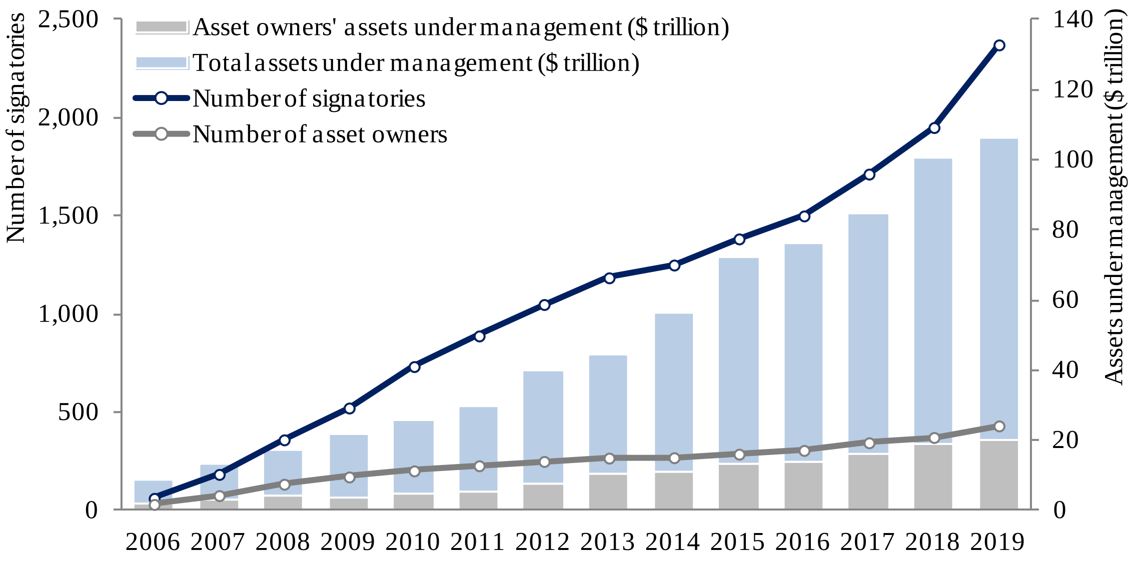
So-called active financial investors will also seek to outperform relevant benchmarks (market, sub-market and industry indices).[54] Public company shareholders will be concerned that any investment, in capital expenditure, research and development or M&A, will be accretive rather than dilutive to a company's earnings and hence create rather than destroy shareholder value. When they receive an offer for their shares, they will expect it to be fully and fairly priced.

[54] Supra note 35.

## 3. Other objectives

Investors began to consider non-financial, in particular social and ethical issues, in the 1960s when some investors excluded stocks from their portfolios if a company's business activities were related to unethical products or labour practices.[55] Since then, environmental, social and governance ("ESG") considerations and alignment with related values have grown in importance. ESG refers to three important factors in measuring the sustainability and ethical impact of investment in a company or business. They were summarised in 2006 in the UN Principles for Responsible Investment ("PRI"), a joint initiative of the UN Environment Programme Finance Initiative and the UN Global Compact, which has become one of the leading corporate responsibility instruments developed by the financial sector.[56]

PRI are intended to encourage investors to incorporate ESG issues into mainstream investment decision-making and ownership practices. They are based on the premise that institutional investors and asset managers have a duty to act in the best long-term interests of their investors and therefore need to give appropriate consideration to how ESG issues can affect the performance of investment portfolios. The PRI have attracted strong support and the number of PRI signatories has grown rapidly to more than 1,800 signatories representing over USD $68 trillion in assets under management as of April 2017.




*Source: PRI Association*

[55] Schroders, Global Investor Study – *A short history of responsible investing*, 28 November 2016, www.schroders.com; Investopedia, *A History of Impact Investing* (by J. Lumberg, updated 22 June 2017), www.investopedia.com.

[56] www.unpri.org

*Figure 3: Number of PRI signatories*

This is despite the often stated concern that incorporating ESG factors into the investment process might hurt returns for investors.[57] However, a large number of studies have argued the opposite, i.e. that ESG investing has had a positive effect on performance across asset classes.

A recent landmark study has reviewed more than 1,200 academic studies undertaken in the past 40 years, which have examined the relationship between ESG factors and corporate financial performance.[58] More than 90% of them have found that ESG had a positive or neutral impact on financial returns.[59]

Their views are supported by the performance of the MSCI KLD 400 Social Index shown below. This index, which comprises companies with strong sustainability profiles, has outperformed the S&P 500 since April 1990 through April 2018 with annualised returns (compound annual growth rate) of 10.9% vs. 10.3%.

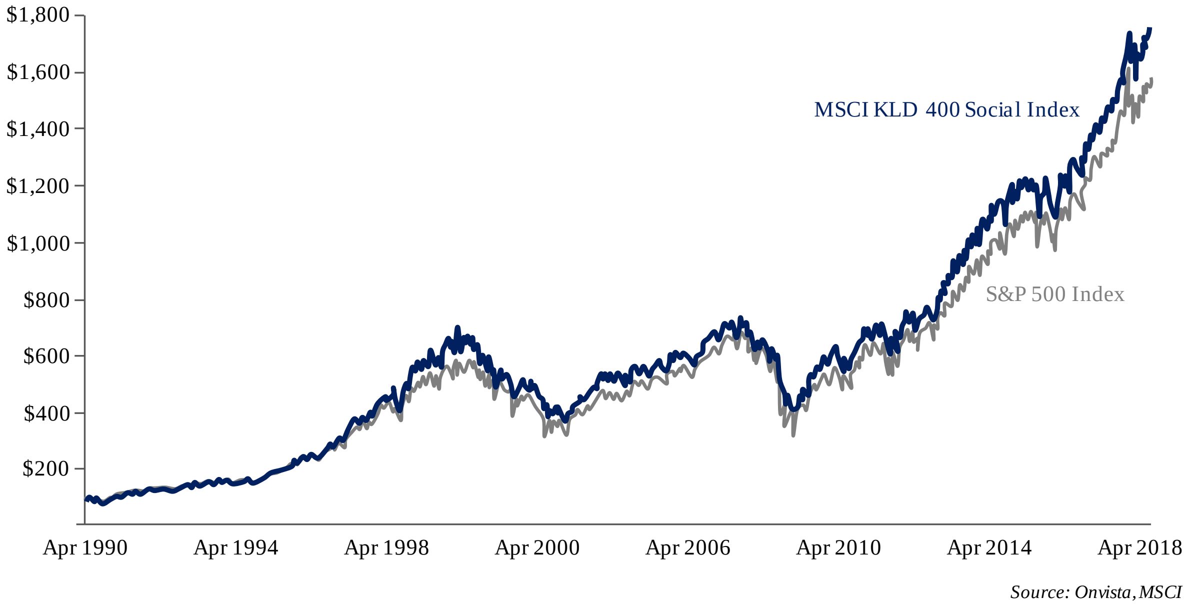



*Figure 4: MSCI KLD 400 Social Index*

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[57] www.msci.com/What is ESG?/Why ESG is growing?

[58] G. Friede/T. Busch/A. Bassen, *ESG and financial performance: Aggregated evidence from more than 2.000 empirical studies*, 5 Journal of Sustainable Financial Investment, 210-233 (2015).

[59] Id., p. 217.

## 4. Activist shareholder objectives

Activists pursue strategies that aim to create or unlock value for shareholders. Their objectives include: Improving transparency and shareholder communication; achieving best of class operating performance and improvements; optimising capital structure and cost; improving corporate clarity, structure and portfolio; and implementing best of class corporate governance and increasingly also other ESG factors.[60]

M&A related activism has become common practice and features now as one of the most frequently pursued campaign objectives.[61] Activists advocate for an M&A transaction, in particular the sale or spin-off of a division, when they are convinced it no longer fits, does no longer add value and therefore ties up capital that can either be better employed elsewhere or should be returned to shareholders.[62] They also oppose or even intervene in M&A bids, which they don't perceive to be value accretive (as bidder shareholder) or to represent full value for their shares (as target shareholder).[63]

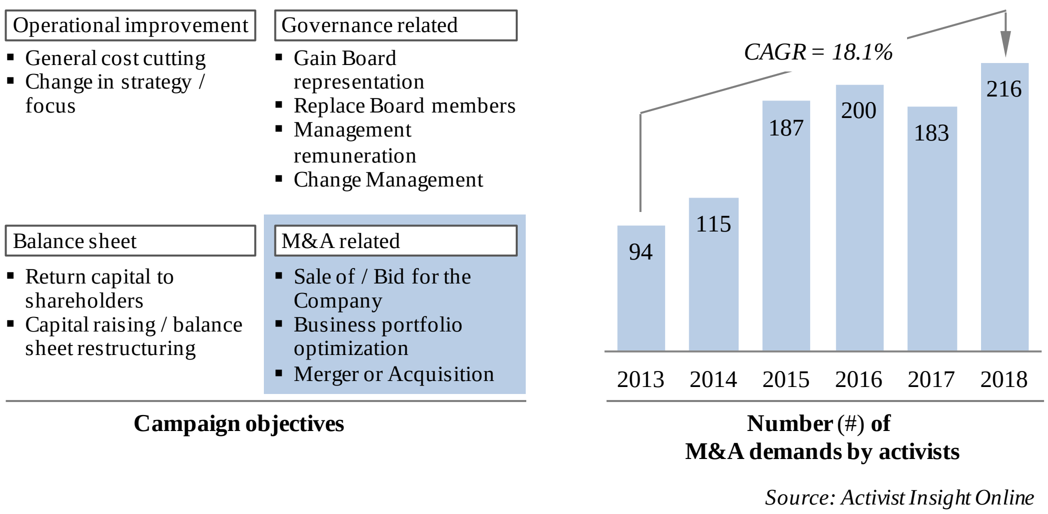


*Figure 5: Activist shareholder objectives*

[60] Activist Insight, *ESG did prove to be a consistent theme in 2018*, The Activist Investing Annual Review 2019, pp. 7, 13.

[61] A. Georgieff/F. Bretag, supra note 1, pp. 5, 18.

[62] Supra note 37.

[63] Supra note 1, p. 18.

## V. Public company ownership concentration and implications

Historically, ownership of most public companies was heterogeneous, divided amongst a large number of unrelated shareholders. The problems associated with widely dispersed ownership of public companies were identified and discussed by A. Berle and G. Means in their classic treatise *The Modern Corporation and Private Property* (1932), in particular the lack of influence of apathetic shareholders on corporate governance leading to “management control” of the company. However this does no longer seem to be the case.[64] The previous trend towards dispersion has been reversed by the rise of institutional investors.

High ownership concentration has emerged over recent years in major equity markets, including in the United States (with reference to the S&P 500 index, the world's leading equity index by market capitalisation) and in Germany (with reference to the DAX 30 equity index).

According to a recent analysis[65], the three largest institutional investors collectively owned 20.5% of the S&P 500, from only 5.2% in 1998[66]. State Street[67] held positions of 5% or more in 139 S&P 500 companies, BlackRock[68] in 488 S&P 500 companies and Vanguard[69] in all (!) S&P 500 Companies.[70] Their combined voting power was even higher at 25.4%[71].

The shareholding structure of DAX 30 companies has also become highly concentrated.[72] By the end of 2017, the reference date of the previously mentioned DIRK/IPREO study, twelve companies had a strategic anchor shareholder with a shareholding of >15% (which corresponds to a de facto blocking minority given relatively low attendance levels at most shareholder meetings). Institutional investors accounted for 61.8% of DAX 30 ownership. The top five institutional investors together owned shares representing approximately 16% of the combined market capitalisation of all DAX 30 companies. The combined share of the top twenty institutional investors was approximately 31%.

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[64] J. Franks/C. Mayer, *Evolution of Ownership and Control around the World: The Changing Face of Capitalism*, European Corporate Finance Institute, Working Paper No. 503/2017, April 2017.

[65] L. Bebchuk/S. Hirst, *The Specter of the Giant Three*, Harvard Law School Program on Corporate Governance, Discussion Paper No. 2019-8 (05/2019).

[66] Id., p. 12 (Figure 1).

[67] State Street Corporation, www.statestreet.com.

[68] BlackRock Asset Management, www.blackrock.com.

[69] The Vanguard Group, Inc., www.vanguard.com

[70] L. Bebchuk/S. Hirst, supra note 65, p. 13 (Table 4).

[71] L. Bebchuk/S. Hirst, id., p. 14 (Table 5).

[72] C. Fohlin, *The History of Corporate Ownership and Control in Germany*, in R.K.Morck (Editor), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers* (2005), pp. 223-281.

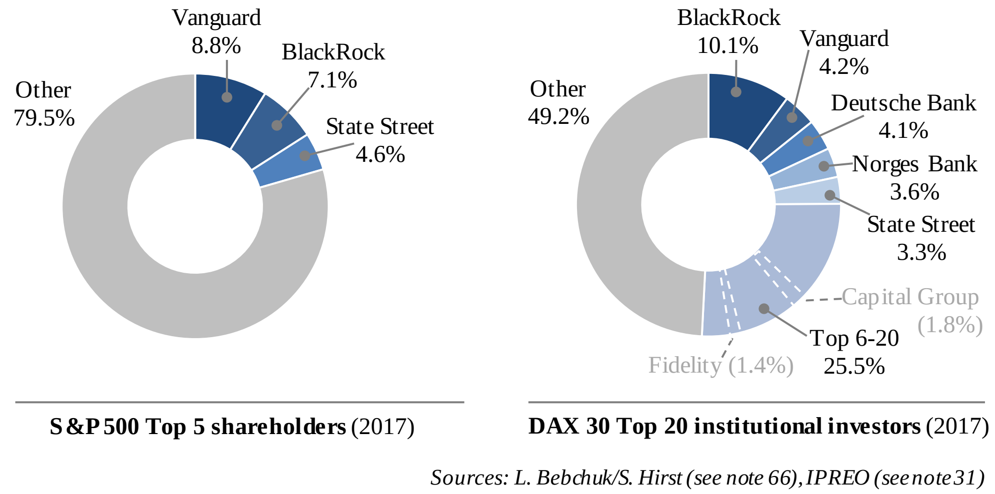


*Figure 6: Shareholder concentration*

Ownership concentration, even at very large public companies, is the result of, inter alia, the continuous institutionalisation and consolidation of the asset management industry[73] as well as the rapid growth of passively investing, low cost index funds.[74] These funds have benefitted from substantial capital inflows in recent years, at the expense of active managers. Total funds flowing to passive investment managers during the past decade (2009-2018) are estimated at approximately $3.5 trillion.[75] During the same period, active managers recorded net inflows of only $192.7 billion. However, net outflows of $670 billion during the last five years up to and including 2018 are pointing to a strongly negative trend for actively managed equity funds going forward.[76] Significantly, the passive fund investment universe is dominated by only three asset managers. According to research from Morningstar, the combined assets managed by Vanguard, BlackRock and State Street amounted to $8.1 trillion as of 31 December 2018.[77]

The rapid growth of passively managed funds relative to actively managed funds is illustrated by the figure below:

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[73] "That small investors would ever pump significant amounts of money into the stock market - that they might someday presume to mingle their savings, bypass banks, and finance companies directly through enormous mutual funds - would have seemed a preposterous flight of fancy … A multitude of trends … was forcing people to set aside more money for their retirement years. Companies were setting up defined benefit plans that bolstered the power of institutional money managers ... In a 1996 survey of the money-management industry, Goldman Sachs flatly predicted that, within five years, the industry would be governed by 20 to 25 giant firms, each with a war chest of at least $150 billion in assets, and one suspects that the prophecy will come true long before then." R. Chernow, *The Death of the Banker*, supra note 10, pp. 34, 48, 78; see also

L. Bebchuk/A. Cohen/S. Hirst, *The Agency Problems of Institutional Investors*, supra note 32, pp. 91-93.

[74] L. Bebchuk/S. Hirst, supra note 65, pp. 5-7.

[75] Id., p. 6.

[76] Id.

[77] Morningstar Direct Fund Flows Commentary, 2018 Global Report, Morningstar Research, December 2018, p. 7.

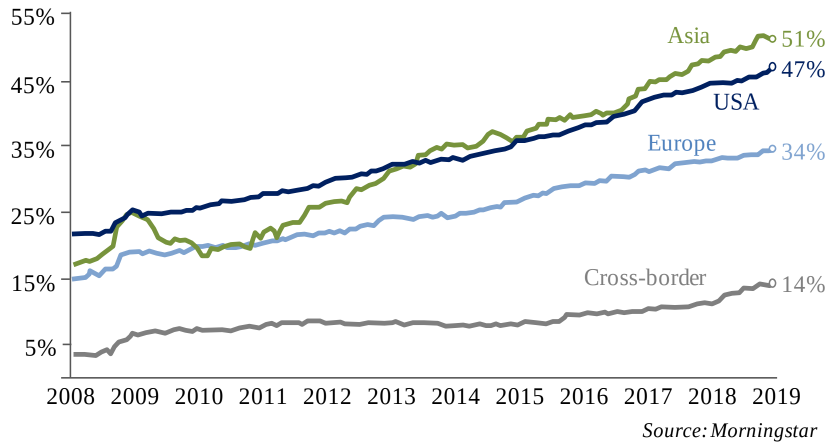


*Figure 7: Percentage of assets in passive funds (equities)*[78]

The implications of the trend towards strong public equities ownership concentration are significant.

First, this trend appears to be continuing. Bebchuk and Hirst estimate that the share of votes cast at S&P 500 companies by Vanguard, BlackRock and State Street (the "Big Three") could reach about 34% in the next decade and about 41% in two decades.[79]

Second, it has created a small number of institutional investors with strong and growing influence in most public companies that are included in an investable index. Their influence is likely to affect the governance of these companies as the inclination for boards to consider the views of, and to consult, their key institutional shareholders more frequently in the ordinary course of their investor relations activities and also ahead of important strategic decisions has grown. However, it remains to be seen whether stewardship activities of these investors will evolve towards an increased use of their powers[80] or remain rather deferential to corporate boards, due to insufficient incentives to invest in and employ resources needed to become more engaged.[81] The implications on corporate governance will be significant in either case.

[78] Id., p. 9.

[79] L. Bebchuk/S. Hirst, *The Specter of the Giant Three*, supra note 65, pp. 15-19.

[80] J. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, Harvard Law School Program on Corporate Governance, Discussion Paper No 1001 (04/2019), pp. 15-16.

[81] L. Bebchuk/S. Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, European Corporate Governance Institute Working Paper Series in Law, Working Paper No 433/2018 (July 2019), pp. 5, 23-32; L. Bebchuk/A. Cohen/S. Hirst, *The Agency Problems of Institutional Investors*, supra note 32, pp. 100-104.

Lastly, it has given rise to antitrust concerns as "… it may cause softer competition among product market rivals because of their significant ownership stakes in competing firms in concentrated industries.[82]"

[82] E. Posner/F. Scott Morton/E. G.Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, pp. 1-2, 11-19.

## VI. Institutional investor stewardship

As mentioned before, the three leading passively investing investors (Vanguard, BlackRock, State Street) have experienced very significant capital inflows in recent years, with more than 80% of all assets flowing into funds managed by these asset managers.[83] They hold large ownership interests, frequently in excess of 5%, in a large number of companies around the globe and are expected to increase their influence over portfolio companies through active stewardship.[84] This view is based on the key characteristics of passive investors (index funds, ETFs): (i) Their large and growing stakes in publicly traded companies; (ii) their inability to exit poorly-performing companies; and (iii) their long-term focus. However, active and responsible stewardship is equally expected from other large investors, including actively investing managers, with significant amounts of assets under management.[85]

Stewardship refers to the actions that institutional investors can take in order to enhance investments in their portfolio companies and includes (i) monitoring; (ii) voting; and (iii) engagement.[86]

Monitoring the operations, performance and governance of portfolio companies provides the informational basis for the voting and engagement decisions of investors.

Voting at shareholder meetings is a fundamental shareholder right. Shareholders vote on all matters which fall into their sphere of competence, in particular the election and removal of individuals to the company's board of directors (the supervisory board in jurisdictions with a two-tier board system) and fundamental decisions such as changes of the company's articles of incorporation and corporate restructurings, including mergers.

Engagement refers to direct or indirect communication between shareholders and their portfolio companies, subject to applicable legal restrictions. It includes informal and formal shareholder proposals, the nomination of directors and proxy campaigns.

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[83] Supra notes 78-79.

[84] J. Coates; supra note 80, pp. 14-19; I. Chiu/D. Katelouzou, *From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?* Nordic & European Company Law Working Paper No. 18-10, pp. 131-152 (2016)

[85] L. Bebchuk/A. Cohen/S. Hirst, *The Agency Problems of Institutional Investors*, supra note 32, p. 94.

[86] L. Bebchuk/S. Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, supra note 81, p. 13; L. Bebchuk/A. Cohen/S. Hirst, *The Agency Problems of Institutional Investors*, supra note 32, p. 95.

In many of the advanced economies, stewardship codes have been drafted to provide guidance to institutional investors on stewardship principles and issues.[87] The revised EU Shareholder Rights Directive also seeks to foster active investor stewardship. It sets a framework to encourage long-term engagement of EU listed companies‘ shareholders and describes new obligations for EU listed companies, intermediaries, institutional investors, asset managers and proxy advisors.[88]

More active stewardship by the world's leading investment managers will also be extremely relevant in relation to public M&A. BlackRock states in its Investment Stewardship Principles on capital structure, mergers, asset sales and other special transactions:

"In assessing mergers, asset sales or other special transactions, BlackRock's primary consideration is the long-term economic interests of shareholders. Boards proposing a transaction need to clearly explain the economic and strategic rationale behind it. We will review a proposed transaction to determine the degree to which it enhances long-term shareholder value. We would prefer that proposed transactions have the unanimous support of the board and have been negotiated at arm's length. We may seek reassurance from the board that executives' and/or board members' financial interests in a given transaction have not adversely affected their ability to place shareholders' interests before their own. Where the transaction involves related parties, we would expect the recommendation to support it to come from the independent directors and it is good practice to be approved by a separate vote of the non- conflicted shareholders."[89]

[87] For example the UK Stewardship Code (2012).

[88] EU Directive 2017/828/EC of the European Parliament and of the Council of 17 May 2017, Official Journal of the European Union L 132/1.

[89] BlackRock Investment Stewardship, Global Corporate Governance Guidelines & Engagement Principles, January 2019, p. 6.

## VII. Legal and financial transaction parameters

### 1. Summary of key legal principles

Most shareholders and board directors of companies, which are domiciled in a developed country and listed at one or several of the major stock exchanges, operate on the general assumption that companies should be run primarily in the interest of shareholders[90]. This assumption is (still) supported by the corporate laws of the US and many other jurisdictions.[91]

In the US, state laws require directors to act in accordance with their *fiduciary duties* towards the corporation and by doing so, to maximise the return to shareholders.[92] The fiduciary duty owed by directors to a corporation and its shareholders has essentially two elements: The duty of care and the duty of loyalty. The duty of care may be summarized as the duty to act in an informed and considered manner.[93] The duty of loyalty requires that a director must refrain from self-dealing and

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[90] The so-called *Friedman doctrine* was developed by economist Milton Friedman and holds that a company's main responsibility is to its shareholders, *The Social Responsibility of Business is to Increase its Profits*, The New York Times Magazine, 13 September 1970. However, this theory and the resulting shareholder value primacy in corporate board's decision-making have become the subject of a growing debate, also in the US. Most members of the influential Business Roundtable signed a Statement of the Purpose of a Corporation, which emphasises a strong commitment to all stakeholders, including customers, employees, suppliers and local communities, while pursuing long-term value for shareholders. *Statement on the Purpose of a Corporation* (Released 19 August 2019), www.businessroundtable.org. The Statement is a reaction to demands from politicians, commentators and important institutional investors that corporations should also serve a broader social purpose. Another initiative, which is led by a group of influential investors, academics and lawyers from Oxford University's Saïd Business School, Berkeley Law School and Hermes EOS (the investment manager's engagement and stewardship division), seeks a public declaration from big companies on how they will "profitably achieve a solution for society". *Oxford Said urges corporate boards to issue a statement of purpose*, www.sbs.ox.ac.uk.

Stronger consideration of stakeholder interests, in line with a long tradition of employee right protection in Europe and employee representation in co-determined supervisory boards of e.g. German companies, was also a key demand in the EU commission's report to the EU parliament and council in 2012 in which it called for, inter alia, "… further dialogue with employee representatives with a view towards exploring possible future improvements to the rights of employees in takeover situations." Report from the Commission to the European Parliament, the council, the European economic and social committee and the committee of the regions, Application of Directive 2004/25/EC on takeover bids, COM (2012) 347 final, p. 11, no. 27.

[91] Although directors have the ability to use their reasoned business judgment to balance the interests of all stakeholders, not just shareholders but also employees, business partners, and national and local communities, are they also obliged to do so?
Martin Lipton, a well-known US corporate law and governance expert, argues that the *business judgement rule* is to be interpreted broadly to encompass the consideration of stakeholder interests. However, he also acknowledges that corporate law still needs to evolve to establish "the broader social mission of the corporation". M. Lipton, *Directors have a duty to look beyond their shareholders*, Financial Times, 17 September 2019. In the meantime, corporate boards continue to be accountable primarily to their shareholders, who may resist the Business Roundtable's declaration as "misleading marketing, at worst a dangerous power grab by overconfident chief executives". G. Tett, *Does capitalism need saving from itself?* (Citing a comment by L. Zingales, Professor of Economics at the University of Chicago), September 6, 2019.

[92] In the US, the board of directors of a corporation is given the authority and is charged with the obligation to manage the corporation by corporate statutes. "In fulfilling their obligation to manage the business and affairs of a corporation, the fundamental relationship that exists between directors and the corporation is a fiduciary one." M. Shehan in A. Georgieff/R. Weber, supra note 17a, pp. 20-21. "In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders." Smith v. Van Gorkom, 488 A. 2d 858, 875 (Del. 1985).

[93] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

be disinterested and independent. He must act in a manner the director reasonably believes to be in the best interests of the corporation and its shareholders.[94]

Under German law[95], corporate boards (both management and supervisory boards) also have a duty of loyalty and a duty of care.[96] They are obliged to observe the corporate interest ("*Unternehmens-interesse*")[97], which constitutes a blend of the original intentions of the incorporators as expressed in the articles of incorporation with the interests of (hypothetical) model-shareholders in the healthy long-term profitability of the company.[98] These interests are generally perceived to converge with the interests of other stakeholders, in particular employees and outside creditors. If there was an undeniable conflict between the interests of shareholders and the interests of other stakeholders, the prevailing view in German corporate law is that the interests of shareholders shall prevail.[99]

Most shareholders expect management to run a company profitably and to optimise the value of their shares, which in the medium to long term means the creation of additional economic value. This is also, and especially, true in relation to a proposed public M&A transaction.

Both German law and U.S. corporate state laws afford board directors significant discretion with respect to the way in which they manage a company and the decisions they make in their pursuit of creating or adding shareholder value, including in relation to M&A. In doing so, they enjoy the protection of the *business judgement rule*.

The *business judgment rule* as developed by the Delaware courts is, in essence, "a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[100] It has been developed by the courts to balance the *fiduciary duties* imposed on directors with the need for the directors to freely exercise their managerial mandate without judicial second guessing or exposure to personal liability. "The *business judgment rule* exists to protect and promote the full

[94] Id., 812, 814.

[95] Reference is made to German corporate law as a proxy for EU member states' corporate laws, given Germany's economic weight within the EU and its civil law tradition.

[96] If members of the management board or the supervisory board breach their duty of loyalty or their duty of care, they can be held personally liable by the company for any resulting damages, §93 para. 1 German Stock Corporation Act.

[97] German Corporate Governance Code, Foreword.

[98] J. Adolff et al., supra note 17, p. 40; U. Hüffer, *Aktiengesetz* (5th edition, 2002), §76, Comments 12-15.

[99] J. Adolff et al., id.

[100] Aronson v. Lewis, supra note 93, p. 815.

and free exercise of the managerial power granted to Delaware directors."[101] Thus, the *business judgment rule* is an acknowledgement by the courts that business decisions should be made in the boardroom, not in the courtroom. Corporations may indemnify directors from monetary liability only for breaches of the duty of care, not for breaches of the duty of loyalty.[102]

The German version of the *business judgement rule*, which protects management board members against allegations of breaches of their duties of loyalty and/or care and was originally developed by the German Federal Supreme Court[103], is now codified in §93 German Stock Corporation Act and in Art. 3.8 German Corporate Governance Code. Accordingly, misguided business judgement does not, as such, constitute a violation of corporate duties (loyalty and/or care). German courts are neither inclined to second-guess the management's strategic decision making.[104] Contrary to the US, it is the board member rather than the plaintiff who bears the burden of proof.[105]

However, in order to mitigate the potential conflicts between principals (shareholders) and agents (directors), lawmakers and courts have defined board directors' duties in the context of corporate takeover (sell-side) situations more narrowly, through the development of important qualifications to the *business judgement rule*.

In the US, the Delaware state courts apply *"enhanced scrutiny"*[106] to the actions of the target company's board in a takeover situation. The board is regarded as a *gatekeeper* that negotiates on behalf of its shareholders. It may take defensive action, but only if it has "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and the action is "reasonable in relation to the threat posed"[107]. If, however, the target has decided to sell itself or the board deems that a break-up of the company is inevitable, the directors' role changes from "defenders of corporate policies" to "auctioneers charged with getting the best reasonably attainable value".[108] In these situations, directors are required to examine competing acquisition proposals and to choose a course of action "reasonably calculated to secure the best value available" to the target's shareholders.[109]

[101] Smith v. Van Gorkom, supra note 92, p. 872.
[102] M. Shehan, in A. Georgieff/R. Weber, *Fairness Opinions*, supra note 17a, pp. 21-22.
[103] BGHZ 135, 244 ("ARAG/Garmenbeck").
[104] J. Adolff et al., supra note 17, p. 43.
[105] §93 Para.2 s.2 German Stock Corporation Act.
[106] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d, 946, 954 (Del. 1985).
[107] Unitrin, Inc v. American General Corp., 651 A.2d 1361, 1373 (Del. 1995).
[108] Paramount Comm. Inc. v. QVC Network Inc., 637 A.2d 34, 46 (Del. 1994).
[109] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

J. Travis Laster, Vice Chancellor of the Delaware Court of Chancery, and Afra Afsharipour, Professor of Law at the University of California, Davis School of Law, argued in their recent article *Enhanced Scrutiny on the Buy-Side*[110] that *enhanced scrutiny* should extend to the decisions of buy-side fiduciaries since "the realities of the decision making context can (also) subtly undermine decisions of (…) directors" in buy-side situations,[111] They reason that the resulting possibility of litigation would induce management to seek more frequently a shareholder vote prior to an important acquisition. Their argument builds on empirical studies which found that shareholder voting can provide an important "counterbalance against the self-interest and bias that lead to bidder overpayment."[112]

In the EU, the Takeover Directive obliged member states to enact legislation to regulate takeovers, including the *"no-frustrating action"* rule, which requires boards to refrain from adopting certain defensive measures so as to deny shareholders the right to decide on the offer[113], subject to important exceptions in individual member states[114]. Boards of EU domiciled companies are expected to *advise* their shareholders by issuing a recommendation on the offer[115]; however, their ability to negotiate and hence to maximize value for shareholders in a bid situation is more limited in comparison with their US counterparts.

## 2. The market for corporate control

When a company underperforms, over an extended period of time, be it as a result of an ill-perceived strategy, operating weakness, a bad acquisition or for any other reason, shareholders can and frequently will act to change its management (*internal governance*).[116] However, when they fail to do so, or cannot agree on the type and/or extent of such changes, *external governance* may kick in.[117]

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[110] Supra note 5.

[111] Id., pp. 470, 479.

[112] Supra note 5, p. 444.

[113] Article 3 (General principles), No. 1. ©, Article 9 No.2 EU Takeover Directive.

[114] Article 12 No.1 (Optional arrangements) EU Takeover Directive

[115] Article 9 No. 5 EU Takeover Directive

[116] J. Healy, *The Effectiveness of Internal and External Mechanisms of Corporate Control*, 1 International business & Economic Research Journal 13 (1990), with reference to F. Fama, *Agency Problems and the Theory of the Firm*, 88 Journal of Political Economy 288-307 (1980).

[117] J. Healy, id.

What does this mean? Public companies' shares are listed on a public stock exchange and freely traded. As a result, they are also subject to the forces of the public equity markets, including those relating to *the market for corporate control*.[118] The latter term refers to the role of public company shareholders in facilitating corporate takeovers in situations, in which the share price of a company has fallen below the level at which it would trade if the company was run more efficiently.[119] A company's persistent underperformance often also reflects poor internal governance so that external governance in the form of a takeover offer (or bid) may lead to a change of corporate control or, in other words, a corporate takeover. Underperforming and undervalued companies are attractive takeover targets.[120]

When this occurs, the directors of the target company may fear the loss of their jobs and therefore be inclined to adopt defensive measures in order to thwart a takeover bid, subject to the limitations mentioned above. Such measures, including structural defence mechanisms such as rights plans (commonly known as "*poison pills*"), were widely used by US public companies since the mid-eighties until well into the first decade of the new millennium.

Rights plans, or *poison pills,* are an effective defensive device against abusive takeover tactics and inadequate bids by hostile bidders for US target companies. After the target board has adopted a rights plan and declared a dividend of one right for each outstanding share of the target's common shares, each shareholder receives a right to purchase shares at a specified exercise price. The key feature of a rights plan is the so-called "flip-in" provision. It is triggered when a hostile acquirer's purchases of the target's shares exceed a certain threshold (typically between 10% and 30% of the outstanding shares) and permits the holders of the rights (with the exception of the acquirer) to purchase the target's shares at a discount; the resulting dilution of the acquirer's interest in the target company makes the target prohibitively expensive for the acquirer. The risk of dilution, combined with the authority of a target company's board to redeem the rights prior to a triggering event, gives a potential acquirer a strong incentive to negotiate with the target's board rather than proceeding

[118] The theory of the market for corporate control was first described by H. Manne, *Mergers and the Market for Corporate Control* (73 Journal of Political Economy 110 (1965).

[119] Id., pp. 112-113.

[120] Id., p. 113.

unilaterally. A rights plan, if properly drafted, is not deemed to be preclusive or disproportionate to the threat posed since the board can redeem it; it therefore typically passes the *Unocal* test.[121] (However, rights plans are not permissible in many other jurisdictions. German corporate law limits restrictions of shareholder subscription rights to protect (all) minority shareholders against a dilution of their interest in the company.)

Strong opposition from proxy advisors and institutional investors has prompted many companies to abolish their rights plans, by either terminating them or letting them expire.[122] This happened despite a general recognition by US state courts that rights plans are important tools for boards to protect the interest of a corporation[123], and their willingness to uphold board decisions not to redeem rights plans in response to inadequate offers, to protect an auction or to explore other alternatives[124]. It is a sign of the enormous power and influence, which the "buy-side" (i.e. institutional investors) has gained in recent years.

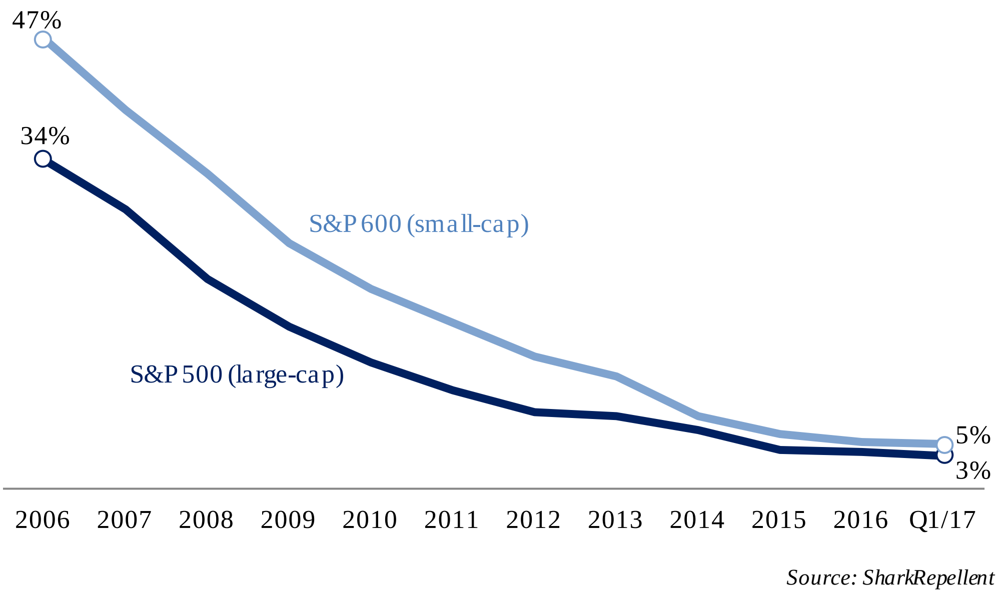


*Figure 8: Companies with a poison pill*

[121] Wachtell, Lipton, Rosen & Katz, *Takeover Law and Practice* (6 March 2019), in Doing Deals 2019, The Art of M&A Transactional Practice by the Practising Law Institute Corporate Law and Practice, Course Handbook Series Number B-2468, pp. 157-164.

[122] Id., p. 158.

[123] Id., p. 162 (with reference to Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1085-88 (Del. 2004).

[124] Airgas, 16 A.3d 48 (Del. 2011).

## 3. Relevant transaction objectives

An M&A transaction must meet target shareholders' price (premium) expectations and still be justifiable to the bidder's shareholders as a compelling opportunity to enhance their wealth as shareholders in order to succeed. Hence, it needs a strong underlying rationale to generate value. It may be pursued opportunistically, when the target company is poorly managed and therefore undervalued, or if it is not, for a range of strategic, including defensive, purposes. Legal and tax loopholes may offer attractive arbitrage opportunities. Whatever the deal reason, it must be good enough to convince a bidder's shareholders that the resources required for a transaction will produce a risk adjusted return, which is superior to alternative strategies available at the same time.

| | |
|---|---|
| Opportunistic | Target company is undervalued |
| Strategic | Markets, products, technology, growth, synergies, restructuring / best practice |
| Defensive | Market consolidation, vertical integration, diversification |
| Financial arbitrage | E.g. acquirer trades at higher valuation levels<br>Market multiples |
| Tax | Tax inversion / tax engineering |

*Figure 9: Public M&A transaction objectives*

## 4. Assessing the financial effects of an M&A transaction

Shareholders expect management to act in their best interest when evaluating a bid for the company or pursuing a (public) M&A buy-side opportunity. When one tries to measure and to evaluate the financial implications of a proposed M&A transaction, the analysis and outcome will be very different depending on which perspective one assumes - the perspective of the bidder (shareholders), the target (shareholders) or "the deal".

In doing so, one must not only focus on the terms of the proposed transaction, but also consider other value creating alternatives. A thorough, case by case analysis may come to the conclusion that declining, or advising against, a deal opportunity and instead concentrating corporate resources on other value enhancing alternatives, including the rigorous execution of an existing business plan, may serve shareholder interests better in certain situations. This type of analysis goes well beyond the more narrow parameters of a fairness opinion, which will consider only the fairness of the terms and process pertaining to an individual transaction as proposed. However, it will not consider a company's strategic and financial alternatives in a broader context.[125]

*a) Drivers of value creation*

The key sources of corporate value creation are a company's operating performance, the cost and allocation of its capital and the structure and efficiency of its portfolio. The shareholder value tree below illustrates the different drivers of shareholder value and is a very useful guide for any related analysis. Regular benchmarking reviews help company management and shareholders to identify operational weaknesses and balance sheet inefficiencies, and to provide guidance for decisions about best ownership of portfolio companies and the corporation itself. Key operating and financial benchmarking metrics include sales growth, earnings margins, cash conversion, cost of capital, economic value added and share price performance.

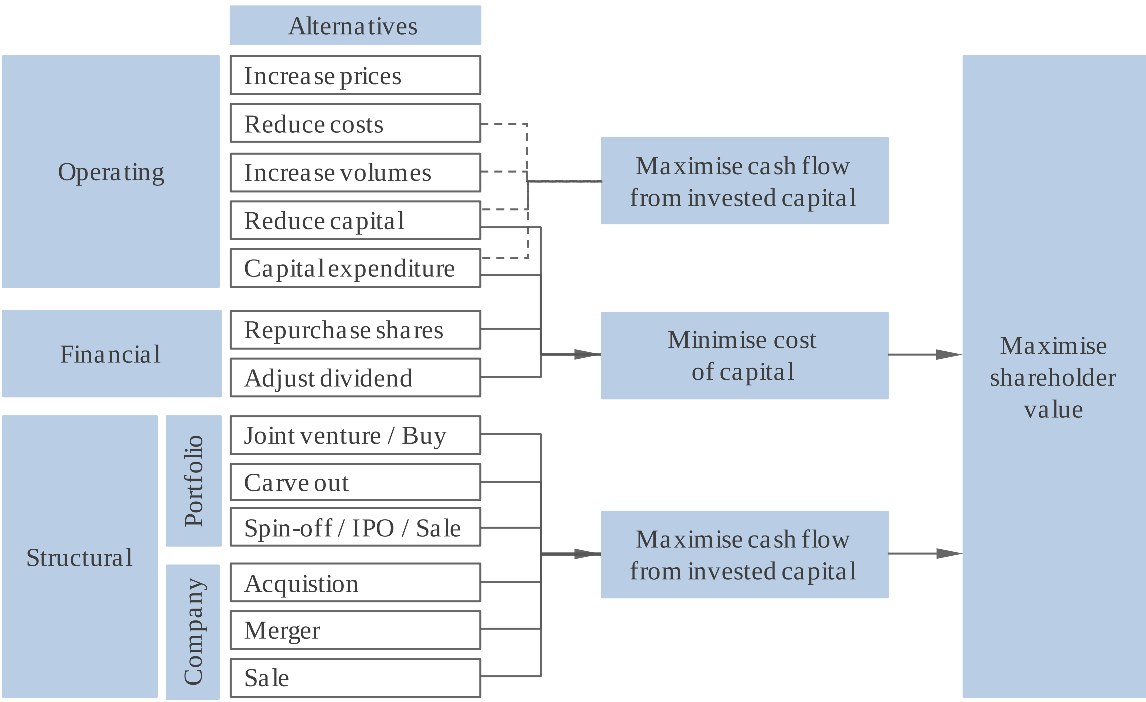


*Figure 10: Shareholder value tree*

A company's management must consider carefully its capital allocation and funding options. It must strive to earn a return with its business and investment activities that exceeds its cost of its

[125] A. Georgieff/R. Weber, supra note 17a, pp. 23-26, 36-42.

capital. Many companies use a combination of debt and equity to finance their businesses. Their overall cost of capital is therefore derived from the weighted average cost of all of its capital sources (WACC)[126]. No matter whether a company's financial resources are directed towards internal growth or efficiency enhancing opportunities, through operating or capital expenditure, or corporate acquisitions, each potential investment (expenditure) must be expected to exceed its cost of capital, on a risk adjusted basis, in order to add economic value (EVA)[127].

Share buy-backs have become a popular tool to optimise a company‘s capital costs, and their possible use and potential effects are frequently applied as a benchmark for corporate investments, including M&A. When a company buys back its own shares, it uses corporate funds to reduce the total number of shares outstanding, which will lead to an increase of its earnings (EPS) or cash flow per share (CFPS) and may trigger an increase of its share price, provided its risk profile and WACC do not suffer as a result.[128] Companies have in the past few years come under pressure from their shareholders, in particular from activist investors, to pursue balance sheet optimisation through buy-backs in order to deliver low-risk short-term earnings growth by exploiting very low borrowing costs.[129] They may have also been pursued as a convenient and potentially less risky value generating alternative to acquisitions, given strong competition for acquisition opportunities from both strategic and financial investors, yet despite highly elevated market valuation levels driven by strong demand for equities.[130] However, critics of share buy-backs view them as a failure of management to identify value generating investments in growth and innovation, and argue that they artificially inflate EPS and CFPS.[131]

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[126] R. Brealey/S. Myers, *Principles of Corporate Finance*, Chapter 19-1, Sixth Edition (2000); T. Copeland/T. Koller/J. Murrin, *Valuation: Measuring and Managing the Value of Companies*, Chapter 8, Second Edition (1995).

[127] *Economic Value Added* was introduced as a performance measure in the late 1980s by Joel Stern and G. Bennett Stewart III. EVA is a registered trademark of Stern Stewart & Co. Economic value is only created if the rate of return on capital employed in a project or company is higher than its cost. G. Friedl/L. Deuschinger, *A Note on Economic Value Added*, TUM Business School (2008).

[128] *What is a Share Repurchase?* www.corporatefinanceinstitute.com.

[129] E. Ervin, *Are Activists Right to Press Companies for Stock Buybacks and Dividends?* 23 June 2015, www.thestreet.com.

[130] Share buy-backs by US corporations have significantly supported their share prices in recent years. Spurred by the US corporate tax reform in 2017, which facilitated the repatriation of funds held abroad by US corporates, share repurchases by S&P 500 companies set a full year record of $806.4 billion in 2018, Investopedia, www.investopedia.com; E. Yardeni/J. Abbott/M. Quintana (Yardeni Research), *Stock Market Indicators: S&P 500 Buybacks & Dividends*, 21 June 2019, www.yardeni,com.

[131] O. Ezekoye/T. Koller/A. Mittal (McKinsey & Co.), *How share repurchases boost earnings without improving returns* (April 2016), www.mckinsey.com; L. Thomas/R. Profusek/L. Ganske (Jones Day), *Share Buybacks Under Fire*, Harvard Law School Forum on Corporate Governance and Financial Regulation, 21 May 2019, www.corpgov.law.harvard.edu.

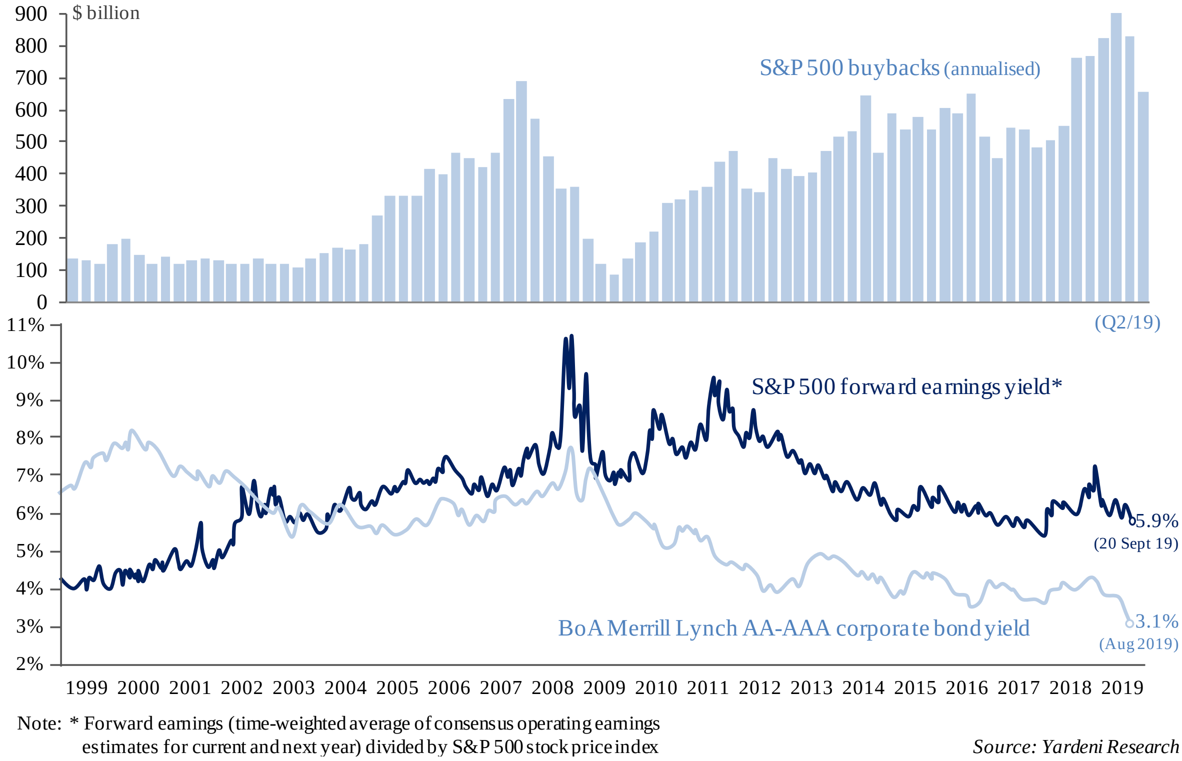



*Figure 11: S&P 500 buybacks*[132]

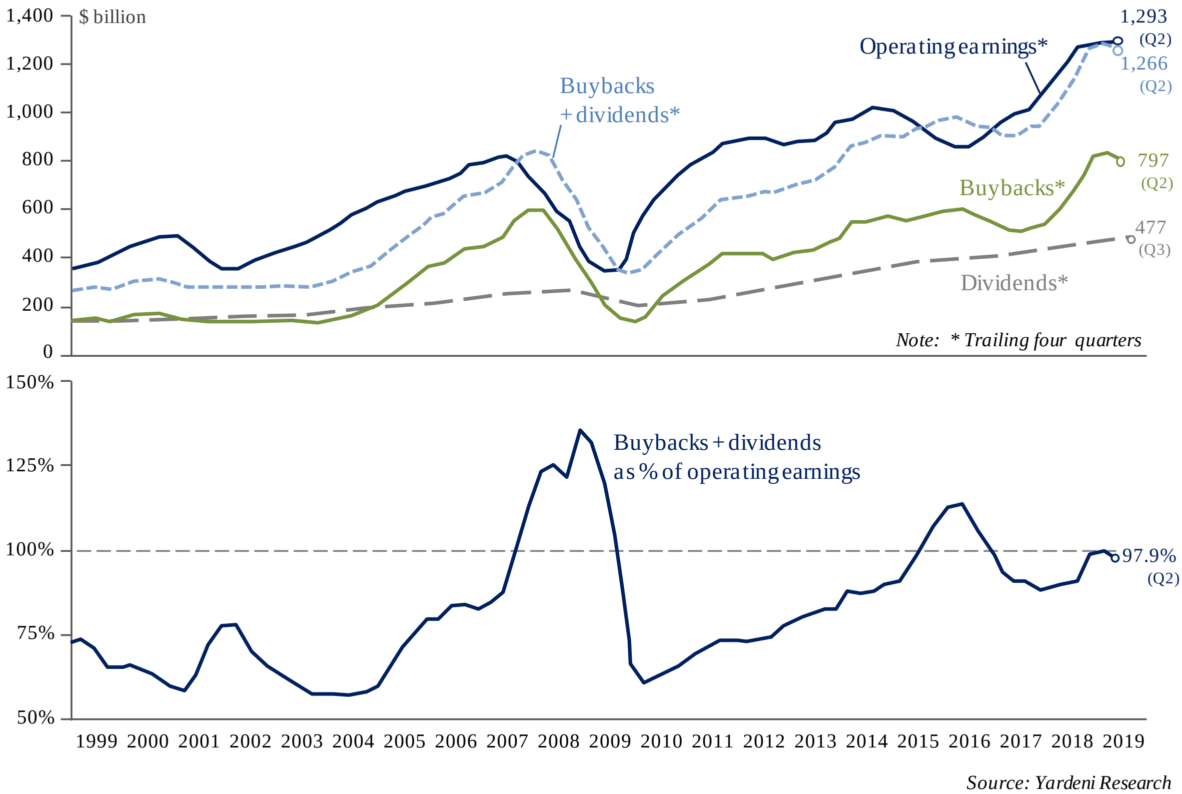



*Figure 12: S&P 500 buybacks, dividends & operating earnings*[133]

[132] E. Yardeni/J. Abbott/M. Quintana (Yardeni Research), supra note 130, Figure 6.

[133] Id., Figure 12.

*b) Bidder shareholders perspective*

A bidder should pursue an M&A opportunity only if its management is convinced that it will add value for the company's shareholders, over and beyond the value development that can be expected in the absence of the proposed transaction. It will have to engage in thorough financial and risk analyses to estimate projected earnings and value accretion under different business and financial plan scenarios. The premium a bidder must offer in order to convince target company shareholders to accept its merger proposal or to accept its public offer and tender their shares ought to be justified by the net present value of the net synergies it can reasonably expect to achieve during the plan period and thereafter in perpetuity.

| | |
|---|---|
| Earnings accretion | Value creation through earnings accretion (earnings today, divided by number of shares today; earnings post merger – i.e. combined pro-forma earnings, incl. synergies, one-off and acquisition financing costs, divided by number of shares post merger (including shares from a possible share offering) |
| Share re-rating | Value creation through expected bidder share re-rating |
| Effect on bidder's share price | Is bidder's value, measured by its share price, expected to increase or decrease as a result of a (proposed) transaction – on announcement, completion or within a quantifiable period of time thereafter? |

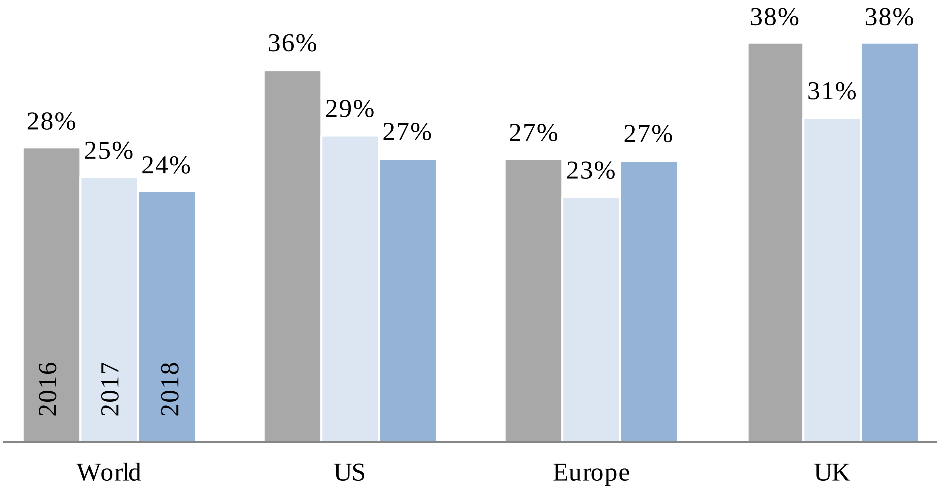
*Figure 13: Value creation considerations*

| **Market related** | | **Operating performance related** | | **Deal related** | |
|---|---|---|---|---|---|
| Causes | Political, economic, financial, natural | Profit / Cash Flow | Sensitivity analysis with respect to growth, margin, synergy assumptions | Cash Flow | Failure to gain access to target's cash flow |
| Effects | Disruption of equity and/or credit markets, political and/or administrative processes | Liqui-dity | Headroom analysis with respect to operating cash flow, integration cost, CAPEX) | Liqui-dity | Refinancing risk (e.g. market freeze) |
| Impli-cations | (Un-)Availability of debt and /or equity finance, volatility, uncertainty | Coven-ants | When will I get into trouble with the banks? | Other risks | Regulatory, litigation, tax, etc. |

*Figure 14: Financial risk assessment*

*c) Target shareholders perspective*

In contrast, target company shareholders will compare the offer price with the expected price development of the target shares if the target remained independent and continued to execute its existing or any alternative business plan, after taking into account any potential strategy and business execution risks and the time value of money (cash in hand now versus sometime in the future). They will also compare the control premium implied in the offer price with bid premiums offered in comparable transactions. However, their return on investment will depend to a significant degree on their respective cost basis and holding period.




Note: Bid premia refer to four week stock price prior to announcement *Source: Mergermarket*

*Figure 15: Public M&A bid premiums*

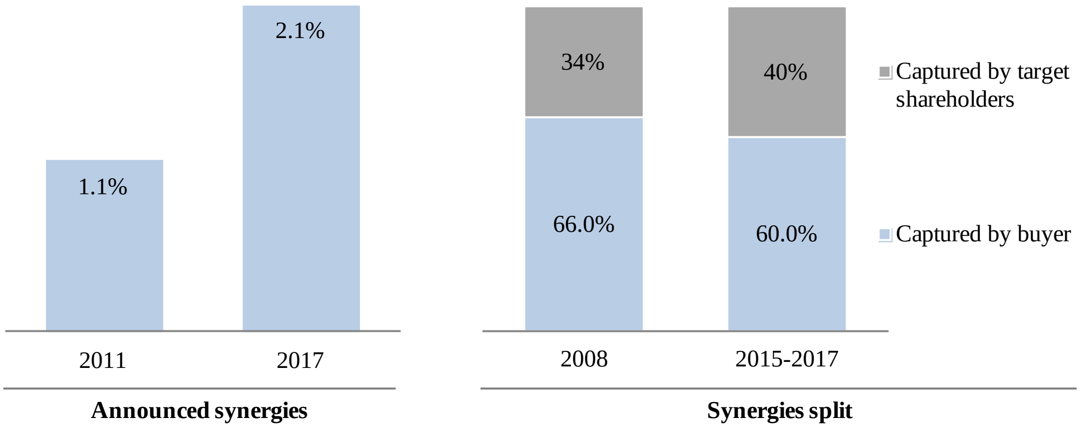
*d) Deal perspective*

Ideally, the economics of an M&A transaction will not result in a zero sum, or even worse, but rather in a positive deal return. This means that the difference between the sums of the bidder's enterprise value and the target's enterprise value before and after the deal announcement ("deal return") should be a positive number. The key factors that drive deal returns are the amount of expected deal synergies, the deal premium and a possible re-assessment of the bidder's shares by the market in the form of a re-rating or a de-rating.

Any analysis will be premised on the *efficient market hypothesis*, i.e. that the undisturbed (pre-bid) share price represents the net present value of a company's expected future cash flows, based upon publicly available information on the company, its assets, liabilities and business prospects.[134]

The takeover bid premium reflects the bidder's expectations of achievable deal synergies and the level of bid competition (real or perceived).

Target shareholders will aim to maximize the premium, and hence their share of potential synergies, in exchange for transferring control (strategic direction and cash flow), whereas the bidder will want to keep the bid premium as low as possible to discount for deal risk (market, business, integration, etc.) and to retain as much of the future upside as possible. Deal returns, therefore, depend on the estimated value of total net synergies and the result of the bargain between bidder and target concerning the synergies split, which will determine the size of the bid premium.




*Source: Boston Consulting Group*

*Figure 16: Transaction synergies*

*e) Merger return analysis*

There are two different more or less widely applied approaches to measuring M&A deal value creation:

The analysis of *pre-merger returns* involves the examination of abnormal stock returns to the shareholders of both bidder and target around the announcement of an offer. It is a commonly used tool to measure the likely deal value creation or destruction associated with an individual M&A

[134] E. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 Journal of Finance 383-417 (1970).

transaction or the overall results of a company's M&A activities during a chosen period of time.[135] The latter must include both successful (i.e. completed) and unsuccessful bids. Statistically most reliable evidence on whether an M&A transaction creates value for shareholders is believed to come from short-window event studies.[136] These studies define deal value with reference to the combined (bidder and target) change in market capitalisation adjusted for market movements, from e.g. two days prior to two days after announcement, as a percentage of transaction value.

The analysis of *post-merger returns* attempts to assess the impact on shareholder value after the merger has been completed.[137] However, this is in many cases very difficult as typically the target company will cease to report or even to exist (following its integration into the bidder) and the surviving entity continues to evolve and/or change after the transaction. This makes a deal return analysis, which compares financial performance before and after closing, frequently difficult if not impossible.[138]

### *f) Does public M&A create value?*

According to various practitioner studies, the overall success rate of M&A appears to be quite low. In a much cited study from 1999, KPMG arrived at the conclusion that 38% of M&A deals covered by the study did not enhance shareholder returns.[139] Booz Allen, in a report from 2001, claimed that 53% of all deals it had reviewed failed to deliver "expected results".[140]

However, both studies are by now a bit dated. For this reason, and also because the methodologies used by the authors of the afore-mentioned studies are not entirely clear, the results obtained by McKinsey and Boston Consulting Group from their respective pre-merger return analyses, both of which indicate positive average deal returns, appear more relevant now. McKinsey conducted a pre-merger return study on all public transactions announced globally during the period 1997 to 2010, which found that average deal value added amounted to 4.6% of the transaction value.[141]

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[135] Robert F. Bruner, *Applied Mergers and Acquisitions*, (Edition 1/2004), pp. 33, 35.

[136] Id.

[137] Id.

[138] Id., p. 35.

[139] KPMG, *Unlocking Shareholder Value: The Key to Success* (1999), p. 2.

[140] Booz-Allen and Hamilton, *Merger Integration: Delivering on the Promise* (2001).

[141] D. Cogman/C. Buch Sivertsen (McKinsey Quarterly), *A return to deal making in 2010*, January 2011, p. 3, Exhibit 1, www.mckinsey.com.

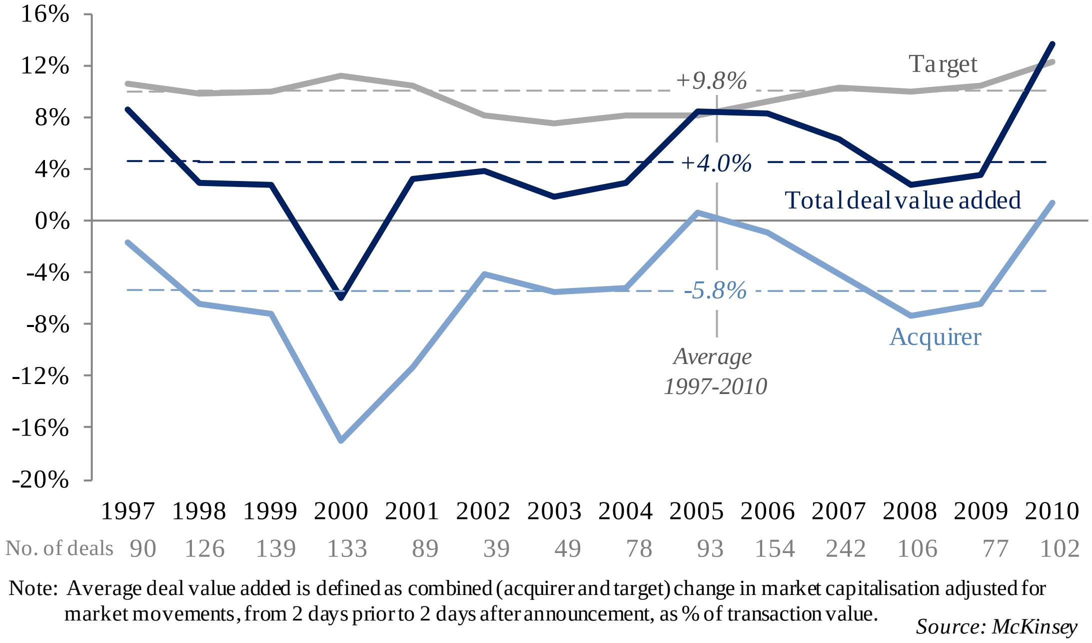


*Figure 17: Average deal value added 1997-2010 (McKinsey)*

An analysis by the Boston Consulting Group covering the period 1990 to 2018 indicates that average acquirer returns were negative at minus 1.1%, but turned positive between 2013 and 2017 (which will also have boosted overall deal returns).[142]

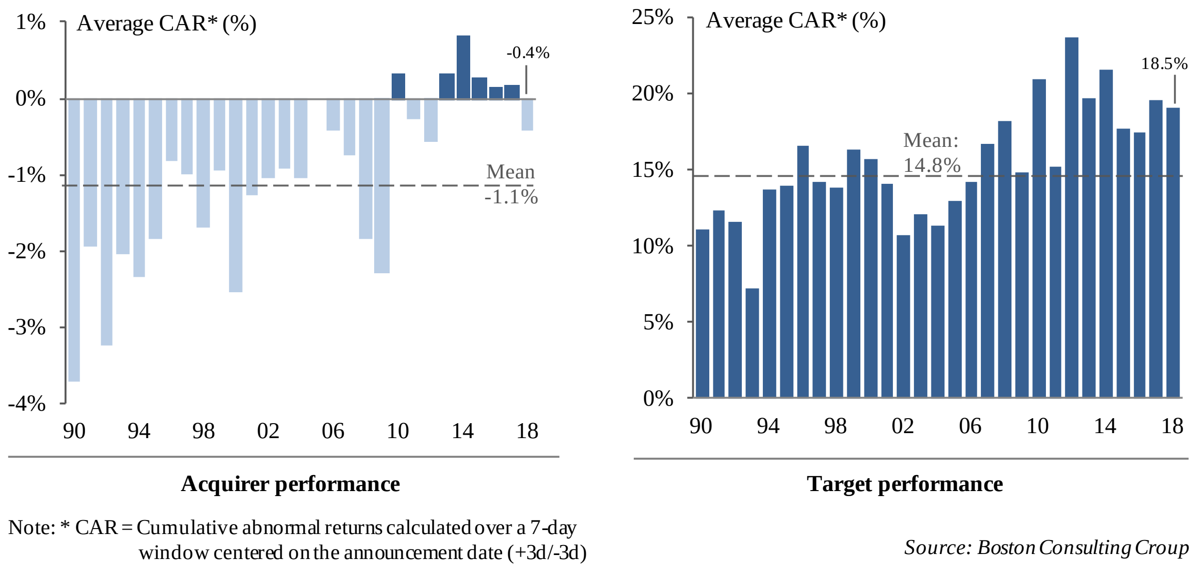


*Figure 18: Cumulative abnormal deal returns in public-to-public deals*

142 Boston Consulting Group, *The 2019 M&A Report: Downturns are a Better Time for Deal Hunting*, p. 11, www.bcg.com.

## 5. M&A deal opposition by activist shareholders

Shareholders need to be convinced of a proposed M&A transaction's strategic rationale and its financial terms, including projected cost, revenue and innovation synergies. They will require detailed information and communication concerning the deal process and analysis, in particular with respect to valuation and consideration of alternatives. If their review leads them to a negative conclusion, they are likely to oppose the transaction.

Many corporate takeovers and mergers attract upon their announcement the interest of event-driven investors such as arbitrageurs and activists, who take a view on, or seek to influence, their success or failure. However, merger arbitrage and activist shareholder intervention in M&A transactions are very different strategies. Merger arbitrage is a strategy where an investor aims to benefit merely from the merger spread.[143] The arbitrageur places a long or short bet on the completion of an announced transaction, which is typically subject to the fulfilment of certain conditions such as minimum acceptance rates or anti-trust clearance. By contrast, an activist investor actively attempts to create or to exploit the opportunity arising upon the announcement of an M&A transaction by acquiring shares (or share derivatives) to oppose it in order to either force an alternative, potentially more value accretive strategy or to demand better deal terms.[144] The latter option is also referred to as *bumpitrage*.[145]

Both activists and arbitrageurs may also seek to benefit from the potentially attractive upside from a successful appraisal or minority shareholder squeeze-out process.

Although activist investors have been known to pursue M&A strategies such as inducing companies to consider an acquisition or to sell a division, or even bidding themselves, more recently they have often simply opposed deals.

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[143] H. Bader/A. Georgieff, supra note 41.

[144] A recent study by Activist Insight, supra note 60, p. 5, has shown that more than 35% of M&A related activist demands globally between 2013 and 2018 sought to prevent a transaction as proposed. Another study revealed that out of a total of 53 merger votes or tender offers at US companies with a market capitalisation exceeding $500 million, and which have been targeted by activist investors between 2010 and 2017, 16 have failed to complete (14 of which were withdrawn, and 2 were still pending), Practising Law Institute, *Hostile M&A and Activism, Hot Topics in Mergers & Acquisitions 2018*, October 2018, p. 25.

[145] Activist Insight, *M&A Activism: A Special Report* (2017), p. 8.

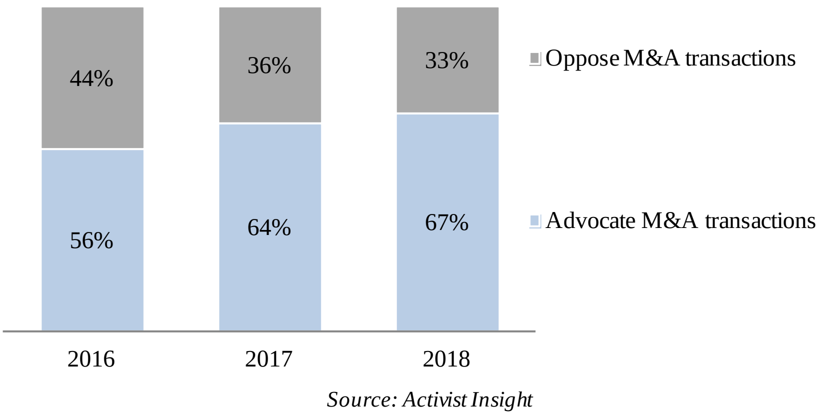


*Figure 19: Activist investor M&A objectives*

Inspired by the success of activist investors, there is a trend amongst large active investment managers, passive index funds and proxy advisors to scrutinize M&A deals more closely.[146] Corporate governance groups at the large index funds with authority to vote proxies and their proxy advisors will consider deal terms and activist investors' arguments, and may vote against transactions.[147] Boards are therefore well advised to seek early shareholder support for their chosen strategy in relation to a proposed M&A transaction.

[146] In its 2019 Europe Summary Proxy Voting Guidelines, ISS stated as key considerations for its M&A deal reviews, amongst others, a proposed transaction's strategic rationale, valuation and the market's reaction, at www.issgovernance.com.

[147] The number of M&A transactions opposed by Institutional Shareholder Services Inc. ("ISS"), the largest proxy advisory firm, doubled between 2014 and 2016 according to ISS Analytics (cited in Activist Insight, supra note 145, p.8).

## VIII. Shareholder voting on important corporate acquisitions

### 1. United States

Both the New York Stock Exchange ("NYSE") and National Association of Securities Dealers Automated Quotations (“NASDAQ”) require an issuer to obtain shareholder approval prior to an issuance of securities that will result in a "change of control". This rule applies if a transaction results in the acquisition of a controlling ownership interest in the issuer by an investor or group of investors. The relevant threshold for control is significantly below 50%: For NASDAQ listed issuers, it is 20%; for NYSE listed issuers, it is between 20% and 30%, depending on the NYSE's review of the issuer's corporate governance structure.[148]

Companies listed on either the NYSE or NASDAQ, which plan to issue shares as sole or part consideration for an acquisition of the shares or assets of another company, also need to obtain shareholder approval of the proposed transaction prior to the issuance of new shares, if the issuance of new shares relates to a proposed acquisition and is equal to or greater than 20% of the number of common stock or voting power outstanding *(“20% rule”*).[149]

However, corporate law and listing rules allow public companies to structure an acquisition to avoid a shareholder vote. For this reason, Afsharipour and Laster have suggested to apply *enhanced scrutiny* also to acquisitions, as a "path to buy-side stockholder voting".[150] They point to recent developments in Delaware case law, which lowered the standard of review applicable to a third-party M&A situation from *enhanced scrutiny* to the *business judgement rule* if shareholders are given the opportunity to a fully informed vote[151]. An extension of *enhanced scrutiny* to acquisitions by public companies, they argue, would induce acquirers to "condition more buy-side deals on favourable stockholder votes, thereby restoring the application of the *business judgement rule* and reducing the directors' exposure to potential liability claims”.[152]

Whether corporate case law will develop to extend *enhanced scrutiny* to acquisitions or not, the pressure of the market (in the form of activists, institutional shareholders and proxy advisors) will force managers and directors to engage more actively with their shareholders on the merits and risks

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[148] NYSE American 713; NASDAQ Rule 5635 (b).

[149] NYSE American Company Guide Sections 712; NASDAQ Rule 5635 (a).

[150] A. Afsharipour/J. T. Laster, supra note 5, p. 488.

[151] Corwin v. KKR Fin. Holdings LLC, 125 A. 3d 304, 308 (Del. 2015).

[152] A. Afsharipour/J. T. Laster, supra note 5, p. 488.

of a transaction and available alternatives, to lower the likelihood of shareholder opposition to a planned deal.

## 2. United Kingdom

Shareholder voting for large acquisitions in the UK is both mandatory and binding for public companies with a premium listing in the UK under applicable listing rules. For companies subject to these rules, certain M&A transactions, including acquisitions and disposals of shares, businesses or assets, may be subject to *Listing Rule 10* and ultimately require prior shareholder approval.

*Listing Rule 10* is intended to cover transactions that are outside the ordinary course of the listed company's business and may change a security holder's economic interest in the company's assets or liabilities (whether or not the change in the assets or liabilities is recognised on the company's balance sheet).[153]

Transactions are classified by reference to the outcome of four *class tests* (gross assets, profits, consideration and gross capital), each giving a percentage, which compare the size of the assets that are the subject of the transaction relative to that of the premium listed company. The tests determine the size of, and consequently the requirements of the Listing Rules that apply to, the transaction in question.[154] Where the transaction involves a sale or acquisition of a company or assets amounting to 25% or more on any of the class tests, it will be classified as a *Class 1 transaction*. The premium listed company will be required to notify a regulatory information service without delay of the key terms of the transaction once agreed and may enter into the transaction only with shareholder approval. Certain dispensations from the need to seek shareholder approval apply to disposals if the company is in financial difficulty. Transactions that do not meet the 25% relative-size threshold under any of the tests, but exceed 5% qualify as a *Class 2 transaction*. *Class 2 transactions* must be notified to a regulatory information service but do not require shareholder approval.[155]

[153] FCA Handbook, Chapter 10, Listing Rule 10.1.4.

[154] Id., LR 10, Annex 1, The Class Tests.

[155] Where the transaction involves a sale or acquisition of a company or assets amounting to more than 5% but less than 25% on any of the class tests, it will be classified as a Class 2 transaction and the premium listed company will be required to notify a regulatory information service without delay of the key terms of the transaction once agreed; FCA Handbook, Chapter 10, LR 10.2.2 (2) and (3).

Becht et al. describe the UK system as "close to ideal because shareholder voting on large acquisitions is mandatory, binding and imposed via a series of threshold tests."[156]

### 3. Germany

The powers of shareholders in public companies, whose corporate domicile is in Germany, are limited by statute. This also concerns their role in M&A transactions.

Mergers or other corporate restructuring measures, which are subject to the rules of the German Restructuring Act, require formal shareholder approval (in the case of a merger by the shareholders of both merging companies).[157] So do restructuring measures within a corporate group, such as the conclusion of a domination agreement or of a profit and loss transfer agreement.[158]

The issuance of new shares or the use of treasury shares as purchase consideration in a corporate acquisition requires shareholder authorisation, which must be limited as regards duration, amount and purpose.[159]

However, neither the sale of a subsidiary, division or asset(s), nor the acquisition of another company, regardless of whether it is a private company or a public company, requires the formal approval of the transaction by the (acquiring) company's shareholders, as long as it falls within the exclusive sphere of competence of the company's management board, which is tasked with its operative management.

This is only not the case in very exceptional circumstances, when shareholders may have additional implied powers in accordance with the German Federal Supreme Court's ruling in the *Holzmüller* case[160], over and beyond the catalogue of powers assigned to them by statute. The *Holzmüller* case concerned far-reaching corporate restructuring measures, which were aimed at carving out corporate assets representing approximately 80% of the company's assumed value when they were proposed to be implemented.[161]

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[156] M. Becht et al., *Does Mandatory Shareholder Voting Prevent Bad Acquisitions*, 29 Rev. Financial Studies 3035, 3037 (2019).

[157] §§13 para. 1, 65 para. 1, 76 para. 2 German Restructuring Act.

[158] §291 German Stock Corporation Act.

[159] §§202 para. 1, 203 para. 2, 205 para. 1, 186 para. 3 and 4 of the German Stock Corporation Act.

[160] BGHZ 83, 122.

[161] *Holzmüller* involved the transfer of the company's most valuable assets to its wholly owned subsidiary (which had been formed for this purpose) by way of a contribution in kind. Neither measure required shareholder approval under any of the above-mentioned statutory rules, even though they had the effect of reducing the direct influence of the shareholders over the assets concerned (since

The Federal Supreme Court held that "there are certain corporate restructuring measures, which (despite the fact that there is no explicit statutory provision to that effect) require the approval of the shareholders' assembly prior to their implementation by the management board".[162] The implied powers of shareholders exist "if and in so far as corporate restructuring measures constitute a material interference with rights of the shareholders having such a substantial impact on the status of the shareholders and their economic interest in the corporation that the management cannot reasonably assume that it is entitled to take the decision in this matter within its own responsibility".[163]

The *Holzmüller* doctrine, as it came to be known, remained vague in several respects. This included its scope of application, in particular in relation to mergers and acquisitions. In the following years, the majority of legal practitioners took a cautious stance. They advised their clients to seek a *Holzmüller* resolution in all cases concerning the sale of a subsidiary or activity, in which the sales, earnings or value of the subject of the sale exceeded 25% of the respective number at the level of the parent company or the corporate group. In relation to corporate acquisitions, the relevant threshold was deemed to be higher, and *Holzmüller* resolutions were commonly sought only at levels of 50% or above. Other procedural issues, such as the majority required for a shareholder resolution, or the information to be provided to shareholders ahead of their meeting, were also left unanswered by the Federal Supreme Court's *Holzmüller* decision.

It was not until 2004 that the Federal Supreme Court was given the opportunity to review the position it had enunciated in *Holzmüller*. In its *Gelatine* decisions, the Court affirmed the concept of implied powers vested in the shareholders assembly, which it had established in *Holzmüller*, but emphasised their exceptional nature.[164] It neither created a catalogue of corporate measures to which the doctrine applies, nor did it define a binding quantitative threshold, whose crossing would

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the sole shareholder of the newly formed subsidiary would be represented by its management, which in its sole discretion would exercise all shareholder rights. The Court referred to this effect as "Mediatisierung".

[162] BGHZ 83, 122; J. Adolff et al, supra note 17, p. 19; for an English language review of the Federal Supreme Court’s decision, please refer to M. Loebbe, *Corporate Groups: Competences of the Shareholders’ Meeting and Minority Protection – the Federal Supreme Court of Justice’s recent Gelatine and Macrotron Cases Re-define the Holzmüller Doctrine*, 5 German Law Journal 1057, 1059-1069, 1071-1079 (2004).

[163] BGHZ 83, 122, 131; J. Adolff et al, supra note 17, p.20; These measures neither amount to a transfer of "all or nearly all" assets of a company (§179a Stock Corporation Act), nor require an amendment to the articles of incorporation (§179 para. 1 and 2 Stock Corporation Act), which will only be necessary if a measure affects the "purpose clause" in the articles, both of which would need shareholder approval by a qualified majority (75%) to become effective. However, they have such a substantial impact on shareholders' ownership or economic interest in the company that the management's discretionary right to ask for a shareholder resolution on the proposed measure in Section 119 para. 2 Stock Corporation Act becomes a firm obligation to do so.

[164] BGHZ 159, 30; ZIP 2004, 993; ZIP 2004, 1001.

trigger its application. Instead, it suggested that in order to be deemed material in this context, a measure would have to have a substantial quantitative effect on shareholders' economic interest in the company similar to the one in the *Holzmüller* case (i.e. 80%). Its ruling did, however, clarify the majority required to pass a *Holzmüller* related shareholder resolution, at 75%.

Legal practitioners have since then commonly applied 80% of group sales, earnings or value as the relevant threshold to guide their clients in relation to whether a corporate sale or acquisition needs to comply with the *Holzmüller* doctrine. As a result of this development, shareholders are effectively denied the implied power to vote on even the strategically and financially most important (with reference to their value, their effect on corporate strategy and investor perception) sales or acquisitions, including so-called transformational transactions, that have a substantial impact on the economic interests of shareholders from a capital markets perspective but do not cross the hurdle set by the Federal Supreme Court. It remains to be seen whether, and for how long, this legal doctrine will hold against the growing expectations and, eventually, possible demands of shareholders as a class to have also a vote (say) on significant acquisitions.

The management of German companies may also consider to voluntarily involve their shareholders more frequently prior to proceeding with a significant acquisition by exercising their discretionary right to ask for a shareholder resolution pursuant to §119 para. 2 of the German Stock Corporation Act.

## 4. Summary

Advocates of stronger shareholder involvement in significant corporate acquisitions are primarily concerned with their potential effect on shareholder value, irrespective of the structure of the transaction and the type of consideration. They will welcome the clarity of the UK's *Listing Rule 10* and its transaction *class tests*, which the UK Financial Conduct Authority (“FCA”) is tasked to enforce, and the mechanism provided by Rule 1.2.5 on early consultation. The consultation mechanism gives issuers and sponsors the opportunity to seek the FCA's guidance in relation to the interpretation and applicability of the Listing Rules. This is in line with long-standing UK financial market tradition and practice ("real time" regulatory guidance versus "after the fact" litigation) and should discourage issuers from testing the limits of the Rules by developing structures intended to avoid or to circumvent them.

Critics will complain about the competitive disadvantage inflicted on companies subject to the UK Listing Rules, or similar requirements in the US, which may have to condition the completion of a public offer for a target company on its approval by their shareholders. They might argue that this requirement introduces an element of objective, or subjectively felt, transaction risk, which will make an offer less attractive than other, non-contingent offers. Further, they might also regard the requirement of a shareholder vote on significant acquisitions as an unwelcome interference with the role and responsibilities of the company's management and board(s).

However, irrespective of the applicable jurisdiction and regulatory framework, corporate managers will have to get used to stronger stewardship from increasingly powerful institutional shareholders and their influential proxy advisors, who are likely to closely scrutinise strategically and financially relevant corporate transactions, in accordance with their voting guidelines. They are therefore well advised to seek out the views of their shareholders, formally or informally, prior to proceeding with an important deal. The increased power of institutional shareholders should also incentivise managers of German companies to make more frequent use of their right pursuant to §119 para. 2 of the German Stock Corporation Act to demand a shareholder resolution on acquisitions, which may technically fall into the management's sphere of competence, but have the potential to materially affect shareholders' economic interest in the company, since this will shield them from liability for resulting damages in accordance with §93 para. 4 s.1 of the German Stock Corporation Act.

## IX. Concluding remarks

The shareholder structure of public companies, especially of large companies included in key equity indices, has changed considerably in recent years. A small number of investment managers have accumulated a large share of the funds, which are invested in global equities and hold, on average, very significant shareholdings in many public companies. Their shares are no longer dispersed and they do not rely on management, or the board(s), to represent their interests.[165] To the contrary, their growing power and influence have raised concerns that they may have incentives to induce portfolio companies operating in the same industry to compete less. Eric Posner et al. have referred to this development as “the major new antitrust challenge of our time”.[166]

Institutional investment managers invest on behalf of smaller investors and pension funds, whose ultimate beneficiaries depend on the preservation of their capital and positive investment returns for their retirement and to be able to fund the education of their children. This is why institutional investors must ensure that companies included in their investment portfolios are well run and refrain from value destroying activities or transactions.

Transformational transactions, which can be structured as a merger of equals[167] or as a significant acquisition, were one of the key drivers of the current deal cycle.[168] Sizeable acquisitions were facilitated by low interest rates and the availability of capital to fund them. If unsuccessful, these transactions have the potential to destroy significant value, jobs and customer choice. Because of their magnitude, their failure might harm the performance of even the largest investment funds, and their repercussions can have societal implications.

Market data covering the period from 1990 until 2018 have revealed that average pre-merger returns for acquirers of public companies have been negative (minus 1.1%)[169], with the exception of a brief period between 2013 and 2017, which is likely to have not gone unnoticed with institutional investors and their (proxy) advisors. These investors are expected, and will perhaps become even obliged in future, to engage in more active stewardship of their portfolio companies.[170] Just as their

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[165] A. Berle/G. Means, The Modern Corporation and Private Property (1932).

[166] E. Posner/F. Scott Morton/E. G.Weyl, supra note 82, p. 2.

[167] A. Georgieff/S. Latsky, “Merger of Equals” Transactions – An Analysis of Relevant Considerations and Deal Trends, Working Paper No 153, Institute for Law and Finance, Goethe University Frankfurt (2017).

[168] A. Georgieff/F. Bretag, Key Drivers of Global Mergers & Acquisitions since the Financial Crisis, supra note 1, pp. 7, 9-11.

[169] Boston Consulting Group, supra note 142, p. 11, www.bcg.com.

[170] I. Chiu/D. Katelouzou, From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe? Nordic & European Company Law Working Paper No. 18-10, pp. 131-152 (2016).

influence has caused most public companies in the US to drop their rights plans (*poison pills*), they may also use it in future to obtain formal or informal vetting rights for shareholders in relation to significant acquisitions. Recent research has suggested that mandatory shareholder voting on significant transactions in the UK has contributed "… to limit(ing) value-reducing acquisitions".[171]

Activist shareholders will continue to oppose corporate transactions, which they perceive to lack a convincing strategic rationale and/or to be financially unattractive, by using the full range of governance and communication tools at their disposal.

The acquisition of Monsanto by Bayer has all the characteristics of a bad acquisition, although it is still work in progress and thus too early for a final verdict. Bayer's management did not submit the acquisition of Monsanto to a vote by its shareholders, despite its significant size and associated transaction risks. On the signing date of the merger agreement on 14 September 2016, Monsanto represented 53% of Bayer's enterprise value, which prior to the *Gelatine* decisions of the German Federal Supreme Court would have deemed to be sufficient to trigger the implied right of shareholders to vote on the transaction. Between then and Bayer's annual shareholder meeting on 26 April 2016, Bayer's share price declined by 35% and its market value by approximately €19.2 billion. The company's shareholders refused to exonerate the company's CEO, a rare and exceptional occurrence in corporate Germany. With the benefit of hindsight, Bayer's management would perhaps have decided differently by making use of its right pursuant to §119 para. 2 of the German Stock Corporation Act and submitted the acquisition to its shareholders for their approval. This would have given Bayer's shareholders the opportunity to either reject this transaction due to its considerable financial and reputational risks or to support management's vision of "Creating a Global Leader in Agriculture".[172] However, Bayer's shareholders may yet be given a second chance to vote, albeit not on the acquisition of Monsanto but rather a possible subsequent corporate restructuring, if management yields to external pressure for a break-up of the group, which would require their approval.

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[171] M. Becht et al., supra note 156, p. 45.

[172] Infra note 178.

## Appendix: The acquisition of Monsanto by Bayer - A transaction summary

Bayer's acquisition of Monsanto may go down as one of the most value destroying acquisitions in recent history, eclipsing another unsuccessful transaction involving a German company and a US company, the merger of Daimler and Chrysler in 1998 (which was effectively a takeover by Daimler).[173] It has been criticised as strategically flawed, too expensive, too aggressively financed, and also for insufficient due diligence and risk evaluation.[174]

*Background*

Bayer is a diversified German life sciences company.[175] It comprises pharmaceuticals, consumer health, crop science and animal health businesses[176]. Monsanto Company ("Monsanto") is a global agriculture company based in the US[177], which produces seeds and crop protection products. Intent on actively participating in the consolidation of the global agrochemicals industry (which during 2015 had witnessed the acquisition of the Swiss company Syngenta by Chemchina and the announcement of the merger of Dow Chemicals and Dupont), Bayer announced on 18 May 2016 that it had made an offer to acquire Monsanto.[178] (According to unnamed resources, reported by Reuters in March 2016, Monsanto had approached Bayer earlier in 2016 "to express interest in the latter's crop science unit, in the form of an acquisition or joint venture".[179])

*Strategic considerations*

Bayer's management cited "a convincing strategic logic, (....) the creation of a global leader in agriculture" and (...) "a compelling case for value creation" as the reasons for the acquisition of Monsanto. It also referred to the combined effects of population growth, climate catastrophes and declining hectares of farmland per capita as fundamental drivers of demand for integrated

[173] The Daimler/Chrysler transaction has been widely discussed, e.g. by M. Blasko/J. Netter/J. Sinkey, *The DaimlerChrysler Merger: Short-term Gains, Long-run Wealth Destruction?* 15 Issues in International Corporate Control and Governance, 299-329 (2000); and by S. Finkelstein, *The DaimlerChrysler Merger*, Tuck School of Business at Dartmouth, No. 1-0071 (2002).

[174] Supra note 6.

[175] www.bayer.de.

[176] Until the sale of Bayer Animal Health to Elanco in August 2019.

[177] Until its takeover by Bayer, Monsanto was registered in Delaware.

[178] Bayer's ad-hoc announcement dated 23 May 2016.

[179] Bayer offers to buy Monsanto in global agrochemicals shakeout, 19 May 2016, www.reuters.com.

agrochemical solutions (seeds and traits, crop protection and digital farming), which it would be able to offer as a result of the combination with Monsanto.[180]

However, an alternative view is that the Monsanto takeover was a defensive move, since selling crop sciences would have left the remaining healthcare businesses vulnerable to a takeover.[181]

In its communication with shareholders, Bayer's management did not discuss the pros and cons of any possible strategic alternatives to the acquisition of Monsanto, such as the sale of its crop science division at a premium price (reflecting the strategic value and benefit of control to a purchaser) and re-investment of the proceeds in its pharma business and/or a share buy-back programme. It is therefore unclear whether it ever seriously contemplated and analysed such alternative.

*Bidder and target valuation, planned transaction synergies*

Immediately prior to the disclosure on 18 May 2016 of its initial offer of $122 per share in cash for all of Monsanto's outstanding common shares, per an offer letter dated 10 May 2016[182], Bayer's share price was €94.23 and it had a market capitalisation of €77.9 billion. (One day before Bayer submitted its initial offer to Monsanto, its shares traded at €98.36.) In Bayer's financial report for the year ended 31 December 2015, it had reported adjusted earnings before interest, depreciation and tax (EBITDA) of €10.27 billion and €17.45 billion of net financial debt, which represented a multiple of 1.7x EBITDA.[183] (Bayer's reported adjusted EBITDA per 31 December 2016 amounted to €9.3 billion.[184]) Hence, on 18 May 2016, Bayer's enterprise value of €96 billion (the sum of its equity value and net financial debt) corresponded to approximately 9.3x 2015 EBITDA, or 10.3x 2016 EBITDA.

Bayer's final offer of $128 per share valued Monsanto at an enterprise value of $66 billion, inclusive of net debt, which represented a premium to Monsanto's undisturbed share price[185] prior to Bayer's final offer of 44% (or a total premium of $17.3 billion) and a multiple of 18.6x

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[180] Bayer's presentation for investor conference call, 14 September 2016.

[181] Supra note 6.

[182] Monsanto Company's Proxy Statement on Schedule 14A, pursuant to Section 14(a) of the Securities and Exchange Act of 1934.

[183] www.annualreport2015bayer.com.

[184] www.annualreport2016bayer.com.

[185] 9 May 2016, the day before Bayer's initial written offer to Monsanto.

Monsanto's 12 months trailing earnings before interest, depreciation and tax (EBITDA), or 16.5x consensus 2017 EBITDA.[186]

Bayer planned to achieve annual net synergies of $1.5 billion (80% cost/ 20% sales, but only three years after closing) through the acquisition and, in spite of the high premium offered (11.6x net annual synergies), expected the transaction to be accretive to core earnings per share (EPS) already in the first full year after closing.[187]

*Financing and deal structure*

Bayer and Monsanto signed a merger agreement on 14 September 2016, pursuant to which Bayer would acquire Monsanto for $128 per share in an all-cash transaction.[188] The transaction value represented approximately 53% of Bayer's enterprise value as per the date of the agreement.

To finance the transaction, Bayer raised a bridge loan in the amount of $57 billion, which it syndicated amongst several banks[189] and subsequently refinanced through proceeds from the sale of assets it was required to divest as well as other assets it no longer deemed strategically relevant and the issuance of a mix of new equity and longer dated debt.

Given that it was structured as a cash merger in the US, the transaction did not trigger a statutory approval right of Bayer's shareholders, nor did Bayer's management ask shareholders for their approval of the transaction under *Holzmüller*. Bayer's shareholders were invited only after the offer's closing to subscribe to a rights issue in the amount of €6 billion.

*Deal perception, pre-merger return and merger arbitrage*

The Bayer/Monsanto pre-merger deal return (T[190] minus two days/T plus two days) was negative (minus 2.9%). The poor reception of the transaction and resulting de-rating of Bayer's shares upon its announcement was mainly due to the significant premium implied in the acquisition price, in absolute terms and relative to the expected synergies.

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[186] Supra note 180.

[187] Supra note 180.

[188] *Bayer and Monsanto Create a Global Leader in Agriculture*, Joint Bayer and Monsanto News Release, 14 September 2016.

[189] Bayer News Release, 12 October 2016.

[190] T = 18 May 2016, the day of Bayer's disclosure of its initial offer for Monsanto.

At the beginning of 2017, with Bayer's offer for Monsanto still conditional on the outcome of antitrust investigations in the US and in Europe, which introduced significant deal completion uncertainty, Monsanto's shares traded well below the offer price. The wide spread between the share trading price and Bayer's offer made Monsanto's shares an attractive bargain for arbitrageurs who believed in the ultimate completion of the transaction. They realised a significant gain when Bayer's offer became unconditional and the transaction closed on 7 June 2018.

*Bayer's financial indebtedness after the transaction*

The transaction took much longer to obtain regulatory clearances than anticipated by Bayer (almost two years from the signing of the merger agreement on 14 September to closing on 7 June 2018), which were conditional on significant business divestitures. After the closing of the transaction, Bayer's net debt had increased to €44.7 billion, i.e. 4.8x 2017 EBITDA (per 30 June 2018). By the end of 2018, after the sale of assets (both antitrust related and other, non-core divestitures) and completion of several equity offerings, Bayer's net financial debt was still high at approx. 3,7x adjusted EBITDA, but it kept an investment grade rating by both Standard & Poor's and Moody's.

*Post-closing product liability related litigation and associated financial risks*

In August 2018, a California court ruled against Monsanto in a product liability case by linking a widely used herbicide made by Monsanto to cancer.[191] Faced with class action lawsuits combining more than 18,000 plaintiffs[192], Monsanto may become liable to pay billions in damages. Bayer's share price, which one day after the disclosure of its initial offer for Monsanto had declined to €87.10 (from €94.23 one day before, and €98.36 one day before its initial offer was made), dropped to €83.73 on the day (13 August 2018) after the initial California court ruling (which was followed by further judgments unfavourable to Monsanto/ Bayer[193]).

*Share price performance and shareholder dissatisfaction*

By the end of 25 April 2019, the day before Bayer's annual general meeting ("AGM"), Bayer's share price had fallen to €61.04 (reflecting the considerable litigation risk in relation to Monsanto

[191] Dewayne Johnson vs. Monsanto Company et al., Superior Court of California, County of San Francisco, Case Number: CGL-16-550128.

[192] Monsanto Papers, www.usrtk.org.

[193] Pilliod, et al. vs. Monsanto Company, et al., Superior Court of California, County of Almeda, Case No. RG 17862702, May 13, 2019; Edward Hardeman vs. Monsanto Company, United States District Court, Northern District Court of California, No. C 16-00525 VC, 27 March 2019.

perceived by investors), which represented a decline of €33.18 (35.2%) since 18 May 2016, when its initial offer for Monsanto was disclosed, reducing its market value to only €56.9 billion (less than it spent on Monsanto). The reduction of Bayer’s market value since the date of its initial offer to buy Monsanto on 10 May 2016 is depicted in Figure 20 below.

Since the acquisition of Monsanto was not put to a formal vote by Bayer's shareholders, those shareholders unconvinced by the transaction's rationale could only vote with their feet and sold their shares. A majority of the other shareholders, who kept their shares (or bought them subsequent to the announcement of the acquisition), expressed their disappointment about the company's strategy and share price performance at the AGM in April 2019. Bayer's CEO, who had worked at Bayer for more than thirty years, lost a vote of no confidence when a majority of shareholders present at the AGM refused to pass a resolution to exonerate him.

Given the very substantial impact the acquisition had on Bayer and its shareholders, M. Staake[194] examined the applicability of the *Holzmüller* doctrine in this case.[195] He found that the transaction did not cross the high threshold set by the Federal Supreme Court and hence, despite some remaining doubts and reservations, did not trigger the implied power of Bayer’s shareholder assembly. Staake concluded that Bayer’s management was therefore entitled to close the transaction without shareholder approval, in accordance with the currently applicable case law.[196]

In contrast, if Bayer had been subject to the relevant listing rules in the UK, it could not have completed the acquisition of Monsanto without the prior approval of its shareholders.

*Activist investor engagement*

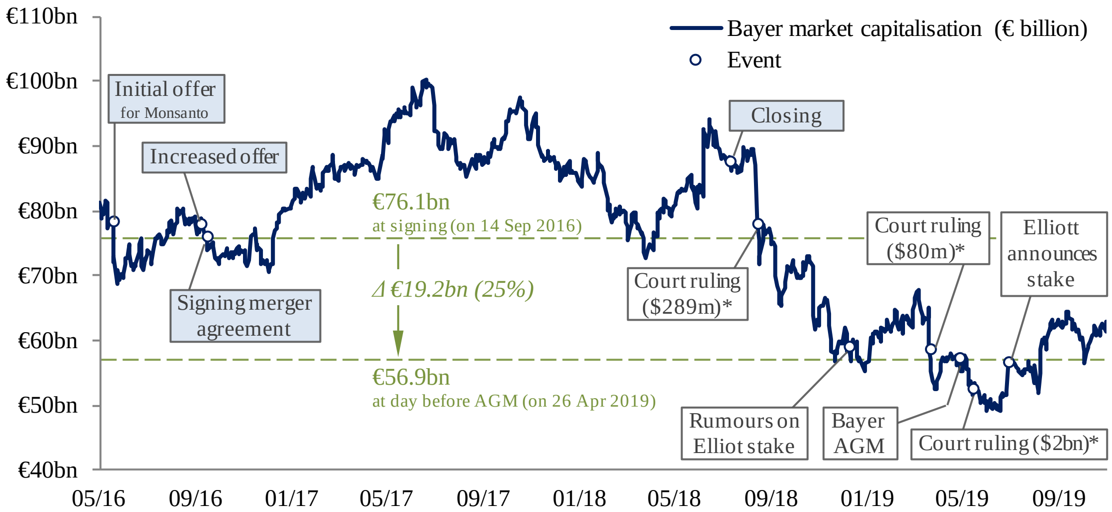
Following Bayer's strongly negative share price performance after the poorly received acquisition of Monsanto and subsequent legal troubles in connection with class action lawsuits brought against Monsanto in the US, some observers suggested that it would make sense to split up the company. Such a move, they argued, would separate the largely unrelated pharmaceuticals and crop science businesses, and be expected to lead to a reduction of the company's valuation discount. Based on their "sum of the parts" calculations, these observers concluded that Bayer was valued significantly below the intrinsic combined worth of its individual businesses. (However, if this happened Bayer

[194] Professor of law, University of Bayreuth.

[195] M. Staake, *Hauptversammlungskompetenzen beim Beteiligungserwerb – Der Fall Bayer/Monsanto*, in J. Stumpf-Wollersheim/A. Horsch (editors), Forum Mergers & Acquisitions 2019, p. 65.

[196] Id. at p. 79.

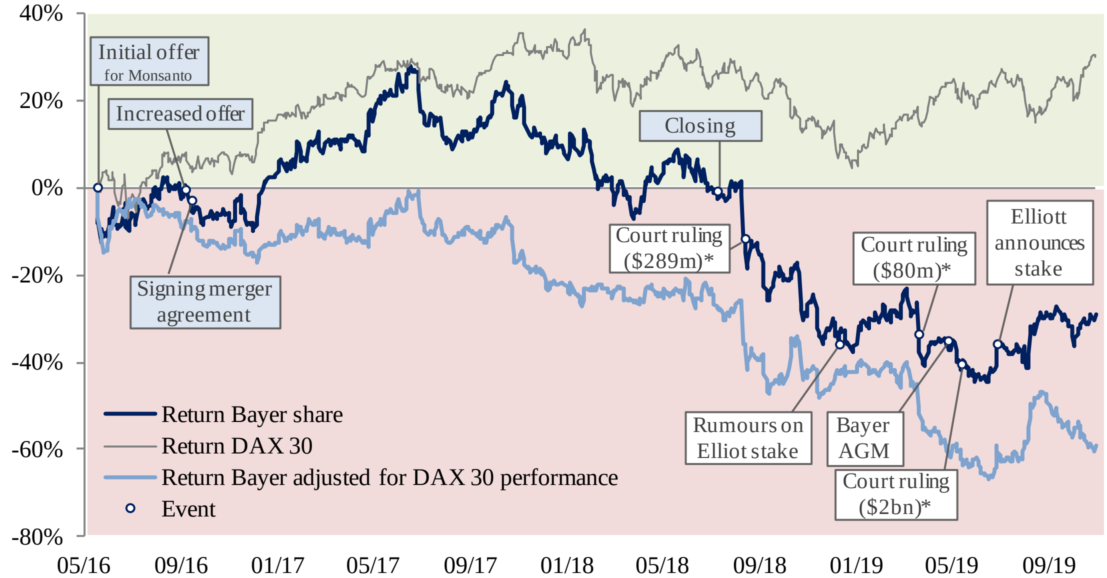
might itself become a takeover target.) On 7 December 2018, it was reported that activist investor Elliott had taken a position in Bayer below the disclosable threshold of 3%[197], later confirmed in a statement by Elliott on 26 June 2019 to be valued at €1.1 billion.[198] Elliott is believed to favour a split-up of Bayer.[199]




Note: * Class action lawsuits brought against Monsanto. Initially awarded damages later significantly reduced

*Source: Onvista, press*

*Figure 20: Bayer market capitalisation*




Note: * Class action lawsuits brought against Monsanto. Initially awarded damages later significantly reduced

*Source: Onvista, press*

*Figure 21: Bayer share price return*

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[197] "*… Activist investor Elliott has stake in Germany's Bayer*" – sources, 7 December 2018, www.de.reuters.com.

[198] "*Elliott says It Holds Stake in Bayer and Sees Value Potential*", 26 June 2019, www.bnnbloomberg.ca.

[199] "*Activist Elliott wields Bayer stake to push 2-way split*", 10 December 2018, www.fiercepharma.com.

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