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Shareholders' Rights & Shareholder Activism

USA

Freshfields Bruckhaus Deringer LLP

chambers.com

2019

Law and Practice

Contributed by Freshfields Bruckhaus Deringer LLP

Contents

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1. Shareholders' Rights

1.1 Types of Company

In the US, most business entities are organised under state law, with the substantial majority of all entities (public and private) organised under the laws of the State of Delaware. Among other forms of entities, Delaware law provides for corporations, limited liability companies ('LLCs') and partnerships.

Most public entities (those listed on the NYSE or NASDAQ, with securities registered under the US Securities Exchange Act of 1934 (the 'Exchange Act')) are Delaware corporations, with other non-corporate publicly traded entities including master limited partnerships ('MLPs') and real estate investment trusts ('REITs'). Privately held entities range the gamut of available entity form, with many individuals, institutions and larger corporate groups choosing LLCs for reasons relating to the enhanced governance flexibility and tax planning.

Delaware does not provide any nationality/residence/status requirements; foreign direct investment limitations, if any, relating to investing in the US will typically arise under rulemaking enforced by and decisions taken by the US Committee on Foreign Investment in the United States ('CFIUS'), an interagency committee authorised to review certain transactions involving foreign investment in the United States, in order to determine the effect of such transactions on the national security of the United States. Industry-specific (state and federal) laws and rules could also be relevant (for example, in the gaming, aerospace and defence, energy and infrastructure, financial and public utilities industries).

Unless otherwise specified, the information herein assumes that the subject corporation is a Delaware corporation with a class of common stock registered the Exchange Act.

1.2 Type or Class of Shares

In Delaware, corporations are permitted to issue common and preferred stock, and to attach rights to each class – broadly speaking – as they see fit (subject to shareholder approval matters). For example, common stock can have no voting rights, proportional voting rights (along the lines of 'one-share/one-vote') or super-voting rights (where each share of high-vote stock is entitled to more than one vote). In addition, corporations can issue preferred stock, with a 'preference' on return of capital and on dividends, and often with other rights that provide for negative control through approval requirements related to enumerated matters.

While most US publicly traded companies (about nine in ten) have a 'one share, one vote' structure, some have a superior/inferior class structure (for example with pre-IPO founders (or their families) holding the superior class (customarily at a 10x multiple). Recently, US institutional investors have recommended to the NYSE and Nasdaq that each amend its respective listing standards to address the issue of multi-class capital structures, such that, going forward, US companies seeking to list with multi-class share structures include provisions in their governing documents that would sunset the unequal voting at seven years following an IPO (subject to extension by vote of a majority of outstanding shares of each share class, voting separately, on a one-share, one-vote basis).

Other, non-corporate, Delaware entities can broadly choose equity capital structures that accommodate their business needs, with the rights being contractually negotiated.

1.3 Primary Sources of Law and Regulation

The rights of stockholders in US companies are, as a general matter, governed by:

- state corporate laws, principally the General Corporation Law of the State of Delaware (the 'DGCL'), which provide for the internal governance of entities in that state;
- the US federal securities laws, principally, the US Securities Act of 1933 (the 'Securities Act') and the US Securities Exchange Act of 1934 (the 'Exchange Act'), including the amendments thereto by the Sarbanes-Oxley Act of 2002, which collectively govern the issuance of, and trading in, securities as well as certain governance matters; and
- requirements of national securities exchanges, such as the NYSE and Nasdaq, which provide additional governance requirements for companies listed on those exchanges.

For example, the procedure and requirements to create a new class of shares are governed by state law, while the sale and trading in such shares would be governed by the federal securities laws and, depending on the quantity of such sale, the rules of the stock exchanges.

In many instances, and with publicly traded companies in particular, there is significant overlap in the manner which the laws and rules regulate. In the election of directors of a corporation, for example, certain issues are governed by state law (eg, the number of directors, the timing required by stockholders that wish to nominate directors, and the timing of annual meetings of stockholders) while other matters are subject to the federal securities laws (eg, certain substantive knowledge requirements for directors, the disclosure materials regarding the annual meeting and liability for material misstatements and omissions in such materials).

1.4 Main Shareholders' Rights

In Delaware corporations, all common stockholders are generally entitled to vote at the election of directors and other extraordinary transactions of the corporation (see **1.8 Shareholder Approval**) and to receive dividends to the extent paid. Further, common stockholders are entitled to the distribution of the remaining assets of a corporation following dissolution after the payment of creditors and, if any preferred stock exists, payment of any liquidation preference on such preferred stock. Other than changes in law, the rights of a class of shares may only be altered by amendment to the certificate of incorporation and/or bylaws (the 'charter documents'), subject to a vote to the extent required by the DGCL or the document itself. The only rights that cannot be altered by a vote of stockholders or cannot be eliminated are the rights those specifically provided so by the DGCL (some of which are discussed in **1.8 Shareholder Approval**) and the fiduciary obligations of the directors to the stockholders.

The certificate of incorporation of a Delaware corporation, and any amendment thereto, must be duly filed with the Secretary of State for it to become effective and are available to the public. Certificates of formation and limited partnership for LLCs and limited partnerships, respectively, must also be filed with, and are publicly available from, the Office of the Secretary of State of Delaware, but do not generally contain substantive provisions affecting the rights of securityholders. Entities that are subject to the US securities laws, including companies completing IPOs must file their charter documents (including bylaws, operating agreements, and partnership agreements) as well as any other instrument affecting the rights of securityholders (and amendments thereto) with the US Securities and Exchange Commission ('SEC').

1.5 Shareholders' Agreements / Joint Venture Agreements

Stockholders' agreements and joint venture agreements are enforceable under Delaware law and can be incorporated by reference into the charter documents of a corporation by reference.

Stockholders' agreements, with respect to public companies, are generally entered into in connection with the entry of large investments (such as private investments in public equity or 'PIPEs') or the exit of a large investor (such as by a private equity sponsor). Such agreements often provide for limitations on further acquisitions or dispositions of shares, governance rights (such as the ability to nominate directors) and transfer restrictions (including, rights of first refusal/offer, tag-along or drag-along rights). While there are certain rights stockholders cannot give up contractually (such as the voting rights of shares themselves), these rights can be altered by contract (for example, one party may agree to vote as recommended by the board of directors or grant a proxy to a counterparty).

Joint ventures are often conducted through alternative entities such as LLCs where there is considerably more flexibility to define rights between the parties contractually as part of the charter documents instead of an outside agreement like a stockholders agreement. The operating agreement for an LLC, for example, may provide that the managers of the LLC do not owe fiduciary duties to the holders of the LLC membership interests, which is not possible in a corporation, other than a specific waiver of corporate opportunities set forth in the charter documents. The ability of parties to LLC agreements to waive fiduciary duties allows parties to ensure that their interactions are governed contractually rather than through the application of common law agency-based duties.

1.6 Rights Dependent Upon Percentage of Shares

With the exception of the ability of a 90% shareholder to complete a short-form merger (see **1.8 Shareholder Approval**), under Delaware law there are no rights under statute that are exercisable by stockholders holding a certain percentage of shares in a corporation. A corporation's charter documents can, however, provide for such rights. For example, the certificate of incorporation can provide that a holder (or group of holders) with a certain percentage of the issued and outstanding stock may call a special meeting or may call for the removal of a director (see **1.12 Shareholders' Right to Appoint/Remove/Challenge Directors**). Of course, a shareholder holding a majority of the shares would be entitled to exercise the rights that require majority approval such as approval or mergers, the sale of all or substantially all of the assets of the corporation and the other items discussed in **1.8 Shareholder Approval**, subject to fiduciary duty owed by controlling shareholder to minority holders in the case of a related party transaction between the corporation and its controlling shareholder (see **3.4 Legal Remedies Against Other Shareholders**).

1.7 Access to Documents and Information

Section 220 of the DGCL provides that stockholders of Delaware corporations have the right to inspect certain corporate books and records provided they have a 'proper purpose' for seeking such materials. A proposer purpose cannot merely be an investigation of potential wrongdoing, but must be relevant to the stockholders interest as a shareholder, such as the intent to launch a derivative action, nominate directors to the board or propose corporate reforms. The scope of the books and records the shareholder seeks to inspect cannot be broader than what is necessary and essential to accomplish the stated, proper purpose. Generally, access to anything broader than board minutes, board materials, and corporate policies and procedures requires a showing that additional specific information in related specific allegations of mismanagement or wrongdoing.

1.8 Shareholder Approval

Under Delaware law, stockholders are entitled to approve: amendments to the certificate of incorporation (and bylaws if provided therein); mergers and consolidations (other than so-called 'short-form' mergers between a corporation and its 90% owner); the sale, lease or exchange of all or substantially all of the corporation's assets; conversion into another entity type (including into a corporate entity in another US state); the transfer or re-domestication of a corporation outside of the United States); and dissolution. These approvals must be obtained in accordance with the DGCL and charter documents of the corporation (see also **1.10 Voting Requirements and Proposal of Resolutions**).

In addition, under NYSE and Nasdaq rules, companies must generally obtain the approval of stockholders prior to issuing shares amounting to 20% or more of their issued and outstanding shares unless such shares are sold in a public offering.

As a general matter, votes to be obtained on matters for which stockholders are entitled to vote may be obtained at an annual meeting of stockholders or special meeting held for the purpose of obtaining such votes. Voting at annual and special meetings may be done in person or by proxy. In addition, consent for such actions may be taken in writing in lieu of a meeting, if permitted by the constitutional agreements.

1.9 Calling Shareholders' Meetings

Meetings of stockholders of Delaware corporations may be called by the board of directors or otherwise as permitted under the corporation's charter documents. Stockholders in Delaware corporations generally do not have the right call meetings of stockholders unless specifically provided for in the certification of incorporation or bylaws. If the certificate or bylaws do provide for such a right, the parameters for determining how that right may be exercised (eg, the percentage of shares that must be represented by the requesting stockholders, or the method and timing of delivering such request) are also set forth in such charter documents.

If there has been a failure to hold the annual meeting or to take action by written consent to elect directors for a period of 30 days after the date designated for the annual meeting, or if no date has been designated for a period of 13 months since the last annual meeting (or the action by written consent to elect directors), the Delaware Court of Chancery may order a meeting of a Delaware Court to be held upon the application of any stockholder or director.

Under the DGCL, notice of any meeting must be given not fewer than ten nor more than 60 days before the date of the meeting to each stockholder who is entitled to vote at such meeting as of the record date. The record date must be not be more than 60 nor fewer than ten days before the date of a meeting.

The form and content of the information required to be submitted to stockholders in connection with stockholders' meetings is generally governed by the Exchange Act and the rules promulgated thereunder. Proxy statements are required to contain detailed information regarding the matters to be voted on as well as the procedures in relation to the vote. With respect to votes for the election of directors, detailed information is required with respect to the identity and qualification of such persons nominated and extensive information regarding the corporation's executive compensation practices must be disclosed in the compensation discussion and analysis section, including full salary, bonus and equity compensation for principal executive officer, principal financial officer and each of the corporation's three most highly compensated employees, as well as information regarding how the corporation determines those compensation levels.

1.10 Voting Requirements and Proposal of Resolutions

If the charter documents do not specific a quorum amount, then a majority of the shares entitled to vote constitutes a quorum at a meeting of stockholders. Under the DGCL, the quorum necessary to conduct business at any meeting may be set forth in the charter documents; however, the quorum may not be set lower than one-third of the outstanding shares entitled to vote at such meeting.

In all matters other than the election of directors and those matters that under the DGCL that require the affirmative vote of a majority of the outstanding shares of the corporation, the affirmative vote of the majority of shares (present in person or represented by proxy) at the meeting and entitled to vote on the subject matter is sufficient to approve the subject to a vote.

Unless otherwise provided for in the corporation's charter documents, directors may be elected by a plurality of the votes of the shares present (in person or by proxy) at a meeting. However, many companies have adopted so-called majority director election provisions for uncontested elections. Under a majority voting structure, if an uncontested director fails to receive a majority of the votes then, depending on the specific formulation set forth in the charter documents, the director failing to receive a majority vote may be removed by the board of directors or must offer their resignation to the board. In most cases, it is up to the board to make the final determination as to whether a board member will continue.

For publicly traded companies, under the proxy rules of the Exchange Act stockholders who have continuously held, for at least one year, at least USD2,000 in market value, or 1% of a corporation's securities that are entitled to vote at meetings, may submit a single proposal for an annual or special meeting by complying with the procedural requirements set forth in Rule 14a-8 under the Exchange Act. However, the corporation may exclude a proposal if it is falls within one of 13 substantive bases for exclusion, including that the proposal relates to the ordinary business operations of the corporation, conflicts with a proposal that is currently in the proxy statement or because the corporation has already substantially implemented the proposal. In addition, the corporation may exclude the proposal if it is procedurally deficient, such as not being made during the appropriate timeframe.

In addition to the requirements under the federal securities laws, in response to pressure from various groups, including large institutional investors, corporate governance watchdogs and activists groups, many corporations have adopted proxy access bylaws (more than 70% of the S&P 500 now having such provisions). While the bylaws differ among corporations, a common formulation allows stockholders (or a group of up to 20 stockholders aggregating their holding) owning at least 3% of company stock for at least three years to submit nominees for directors that will be included in the corporation's proxy materials for up to a maximum of 20% of the board (with a minimum of two directors).

1.11 Shareholder Participation in Company Management

Delaware law provides that the business and affairs of a corporation is managed by the board of directors. As such, unless otherwise agreed pursuant to a stockholders agreement, there is no specific right of stockholders to participate in the management of the corporation or sit on the board of directors. Although rare, some Delaware corporation provide for cumulative voting, which would allow a shareholder to appoint a director if such shareholder had sufficient ownership (see **1.12 Shareholders' Rights to Appoint/Remove/ Challenge Directors**).

1.12 Shareholders' Rights to Appoint / Remove / Challenge Directors

The DGCL does not provide for the direct right of stockholders to appoint directors or require that a Corporation include stockholder's director nominees with the corporation's proxy materials. A stockholder may, on the other hand, by complying with the DGCL and charter documents, nominate its own proposed directors by creating, filing and distributing its own proxy materials - a so-called 'proxy fight'. The bylaws of a corporation may provide, however, that if the corporation solicits proxies with respect to an election of directors, it can be required, to the extent and subject to such procedures or conditions as may be provided in the bylaws, to include in its proxy solicitation materials one or more individuals nominated by stockholders, in addition to individuals nominated by the board of directors (see also **1.10 Voting Requirements and Proposal of Resolutions**). In addition, a stockholders agreement may provide for the right of one or a group of stockholders to nominate directors.

Under the DGCL, any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares entitled to vote at an election of directors, except for boards that are classified, in which case, directors may only be removed for cause. Following the removal of any director from the board, unless provided for in the corporation's charter documents, the remaining members of the board may appoint new directors.

Stockholders do not generally have the right to challenge an action taken by the board of directors other than through a derivative action brought on behalf of the corporation (see **3.6 Derivative Actions**).

1.13 Shareholders' Right to Appoint / Remove Auditors

Stockholders in Delaware companies do not have the right to appoint or remove auditors. Public companies often ask stockholders to ratify the appointment of auditors as part of its annual meeting, but it is not required.

1.14 Disclosure of Shareholders' Interests in the Company

Under the US federal securities laws, a beneficial holder or group of beneficial holders acquiring 5% or more of shares of a corporation with a class of voting equity registered under the Exchange Act, must disclose that ownership by filing a Schedule 13D or Schedule 13G with the SEC.

The type of filing that must be made depends on whether the holder is considered a passive investor (which investors may file a Schedule 13G) or all others, which must file a Schedule 13D. Schedule 13D requires information on the identity and background of the acquiror; the source of funds used for the acquisition; the purpose of the transaction, including planned extraordinary transactions or proposed changes to management; information regarding the interests of the securities of the corporation; and a description of any contracts or arrangements among the reporting persons, and between each reporting person and anyone else, relating to the issuer's securities.

Schedule 13D reports must be filed with the SEC within ten days after the purchase triggering the report. Any material changes to the information in the Schedule 13D must be promptly reported in an amendment.

Schedule 13G reports for passive investors require significantly less information, generally just basic information about the holder, the amounts held and the voting and/or dispositive control over those amounts. Most Schedule 13G reports do not need to be filed or amended until 45 calendar days after the year in which the acquisition occurs.

In addition, officers, directors and holders of 10% or more of a corporation with a class of equity registered under the Exchange Act, must file Forms 3,4 and 5 under Section 16 of the Exchange Act with the SEC reporting changes in security holdings.

Institutional investment managers that have assets under management USD100 million or greater must file reports on form 13-F with SEC reporting their holdings of equity securities that are registered under the Exchange Act as well as certain derivative securities such as warrants, convertible debt and options and warrants. This filing must be made within 45 days of the end of each calendar quarter.

1.15 Shareholders' Rights to Grant Security over / Dispose of Shares

Unless otherwise agreed directly between a corporation a shareholder, such as may be set forth in a stockholders agreement, there are no restrictions on a stockholder's ability to grant security over, or dispose of, corporate stock. As noted in **1.5 Shareholders' Agreement/Joint Venture Agreements**, stockholders agreements are generally enforceable under law and such agreements often include restrictions on disposition and granting security interests.

Under US federal securities laws, every sale or offer of securities that makes use of interstate commerce is subject to the requirements of the Securities Act and, therefore, any such transaction must be registered under the Securities Act or be subject to the one of the exemptions or exceptions thereunder. As a practical matter, stockholders in public companies, unless they are affiliates (as defined under the securities laws) or received their shares directly from the corporation in a private placement transaction, are free to dispose of, pledge or encumber, or otherwise transact in the shares of a corporation freely. Affiliates, including officers, directors and large stockholders, may be subject to limitations pursuant to Rule 144 under the Securities Act, including holding periods and limitations on the volume of shares that can be sold in a given period. Stockholders that received their shares in a private offering may be subject to a holding period before selling.

Finally, granting security over shares can be subject to the margin regulations promulgated by the Board of Governors of the Federal Reserve System.

1.16 Shareholders' Rights in the Event of Liquidation / Insolvency

In the event a US corporation becomes insolvent, the rights of stockholders are determined under the laws of the United States Bankruptcy Code. Generally, stockholders are the residual claimants in a bankruptcy and their recovery is dependent on whether there are excess assets when all creditors have been satisfied. Under Chapter 11 of the Bankruptcy Code, stockholders have the opportunity to participate in the reorganisation process. While stockholders have certain procedural and substantive safeguards, where stockholders are not likely to recover under in bankruptcy, it is likely that their rights will be subordinated to the interests of creditors.

Separately, under Delaware law, upon a determination that a corporation is insolvent, the Court of Chancery, on the application of any creditor or shareholder thereof, may, at any time, appoint receivers to take charge of a corporation's assets and liabilities.

2. Shareholder Activism

2.1 Legal and Regulatory Provisions

There are no specific laws governing or restrict activism by investors, per se. Rather, the legal framework that shareholder activists and companies interact under is part of the broader set of law regarding public companies in the US, including the DGCL, the Securities Act, the Exchange Act, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and rules under the NYSE and Nasdaq.

2.2 Level of Shareholder Activism

While shareholder activism has grown outside the US in recent years, the US is still the predominant market in which activism exists and there are more activist campaigns in the US then the rest of the world combined. According to Activist Insight, 53% of activist campaigns were targeted toward US companies in 2018 and the US had more than six times as many campaigns as the country with the next largest amount. Levels of activism have continued an upward trajectory for many years. For example, the amount of new capital deployed in activist campaigns roughly doubled between 2016 and 2017 and increased again in 2018.

Prominent examples of Activism in 2019 include many that have been focussed on M&A such as Icahn's challenge of Occidental Petroleum's proposed acquisition of Anadarko and Third Point's and Pershing Square's criticism of United Technologies planned merger with Raytheon. Other prominent recent examples include Elliott Management's call for the separation of eBay and Starboard Value, appointing four new directors to the board of health information technology corporation Cerner.

2.3 Shareholder Activist Strategies

Almost all activism campaigns begin with the activist taking a stake in the target corporation. However, the range of activities and level of interaction with the public and other stockholders can be quite varied from quiet 'behind-the-scene' engagement, to public campaigns. Even with the same activist, the strategies will be tailored to the situation: for example, in April 2019, Cerner and Starboard Value announced that settlement pursuant to which Starboard would appoint four new independent directors and Cerner would commit to buyback and margin targets. This was all done without any advanced public pressure on the part of Starboard. On the other hand, in February 2019, Starboard published and mailed to Bristol-Myers Squibb stockholders a detailed 16-page letter on why they should not vote for the Celgene merger.

Where private persuasion or public pressure is not sufficient alone, activists can take additional actions such as launching proxy contests to gain board representation or bring litigation to challenge a board action. According to Factset's SharkRepellent, there were 78 proxy contests in 2018. Historically (2001 through 2018) about one third of all proxy contests have settled and about one-third have gone to a vote, with management winning about 58% of votes held.

Activist agendas in the US are often well-developed and generally quite specifically targeted at a perceived weakness in the target, but the campaigns generally fall into a few categories (although demands often span categories):

- Maximising shareholder value, such as calling for an extraordinary transaction sale or merger or the corporation; a break-up, divestiture or spin-off of non-core business or assets or other balance sheet-related request (for example, Sachem Head proposing that Eagle Materials separate its heavy and light materials businesses).
- Business strategy or operational matters, such as campaigning for new business strategies or initiatives; new capital structure or capital allocation; or the monetization of assets (real estate, IP) through complex structuring (for example, Neuberger Berman pushing software company Verint to pursue a cloud-based business model, enhance its financial reporting and change its capital allocation).
- Corporate governance/board representation, such as securing board seats; changing the CEO or other senior management; pursuing changes to executive compensation, board structure or shareholder rights (for example, Legion Partners, Macellum Advisors and Ancora Advisors campaigning to control the board of directors of Bed, Bath & Beyond and to replace the CEO).

2.4 Targeted Industries / Sectors / Sizes of Companies

One of the key trends in activism over the past several years is that no corporation is immune. Activists have targeted companies across industries, sectors and size and even the largest and most well-known companies have become activist targets. According to Activist Insight, campaigns in 2019 have targeted companies broadly across sectors, including basic materials, consumer goods, financial, healthcare, industrial goods, services, technology and utilities as well as conglomerates operating across sectors. In addition, large cap companies (over USD10 billion) made up over a third of campaigns in 2018 with over 50% of campaigns targeting companies with market capitalisations over USD2 billion. For example, even giant companies such as Bristol-Myers Squibb, United Technologies and Occidental Petroleum have not been immune to activist investors.

2.5 Most Active Shareholder Groups

In the US, most of the shareholder activism is led by activist hedge funds that specialise in activist investing. Some of the post prominent activist hedge funds include Paul Singer's Elliott Management, Daniel Loeb's Third Point, Bill Ackman's Pershing Square Capital, Carl Icahn's Icahn Enterprises and Nelson Peltz's Trian Partners.

In addition to prominent activist funds, infrequent activists – those with fewer than five campaigns over the last five year – brought 68% of all publicly announced campaigns in 2018 and launched 57% of all proxy contests.

It is worth noting, however, that there have been a number of key trends over the past years that are changing the activist landscape. Key among the trends are the increase in 'wolf pack' attacks, where activist hedge funds, arbitrage funds and traditional long-only funds act together in an activist manner. For example, in 2017 and 2018, institutional investor BNY Melon voted for dissident proxy slates over 50% of the time, according to Activist Insight. While others such as BlackRock (7% in 2018 and 30% in 2017), State Street (21% in 2018 and 40% in 2017) and Vanguard (39% in 2018 and 37% in 2017) all were lower, the large holding of those institutional investors can have a meaningful impact on outcomes in proxy fights. The institutional investors, while they do not generally rely on activist tactics such as proxy fights and white papers, have themselves taken an increasingly active role in corporate governance. BlackRock's Investment Stewardship initiative stated goals include, among others, to protect and enhance the value of clients' assets through engagement with companies, and proxy voting, in clients' best long-term economic interests; to encourage business and management practices that in our experience support sustainable financial performance over the long-term; and to provide insight on environmental, social, and governance (ESG) considerations.

2.6 Proportion of Activist Demands Met in Full / Part

Based on data from Activist Insight, over the past three years, approximately 42% of all public activist demands were at least partially satisfied (representing a modest decline from a few percentage points higher in prior years). In recent years, high-profile campaigns have gone both ways – for example, the largest proxy contest in history (Proctor & Gamble/Trian Partners on which USD100 million was reportedly spent by Proctor & Gamble to defend itself) occurred in late 2017 (though it was ultimately not clear whether or not Trian lost the contest, Nelson Peltz was ultimately added to the Proctor & Gamble board), while Third Point's campaign at Campbell Soup ended with the fund obtaining two board seats (and a mutually chosen third director).

2.7 Company Response to Activist Shareholders

Before an activist emerges – regular review leads to readiness

As a general matter, well-advised companies will run their business 'as if' an activist could emerge at any time, thereby beginning their activist response well in advance of any actual contact through careful and regular internal review of their potential vulnerabilities (for example see **2.3 Shareholder Activist Strategies**). Preparation for any activist emergence or contact is likewise careful and advanced, following on from the regular review.

Because activist funds generally aim to create discord between a corporation and its stockholders by focusing on situations where management has failed to unlock value or recognize opportunity (or has exposed disproportionate or unnecessary risk), companies therefore should evaluate their own businesses the way that an activist investor would - this includes evaluating whether: recent past decisions (eg, M&A, investments and other strategic priorities) have been successful; capital allocation strategies been optimised; there remain or have emerged significant dis-synergies within the business; their governance model, and in correlation, their executive compensation model, remain appropriate for the businesses.

More specifically, the regular review touchpoints should include:

- monitoring the corporation's business and operation for situations that are of the type that activists frequently target as issues (see **2.3 Shareholder Activist Strategies**);
- ensuring that corporate strategy and business milestones are clear, allowing for enhanced accountability for performance;
- working with internal and external investor relations professionals and market surveillance firms to monitor stockholdings to determine trading trends of the corporation's stock; and
- staying connected and engaged with all constituents – stockholders, employees, customers and business counterparties, analysts, investors, proxy advisory firms – and ensuring that the messaging is intended and consistent to all of them.

When an activist campaign is revealed

Once an activist campaign has begun, it is crucial that the target corporation have a unified and comprehensive response.

Responding to activist investors requires, in addition to response to the substantive critiques posed by the activist, careful public and investor relations preparation. The response should generally be co-ordinated on a single front rather than piecemeal between multiple executives and board members.

To that end, companies often try to keep interactions with activists private. Once the situation is public, a target's options narrow, including because it can become more difficult for an activist (with its own agenda and investors) to withdraw or modify its course.

If the activist campaign does become public, it is important that responses are measured and substantive. Public and investor relations should focus on the desire for the corporation to engage with all stockholders and listening to their perspectives. The corporation may wish to publish information correcting an activists' understanding or facts asserted, but there should not be a personality-led debate and a corporation should never resort to ad hominem attacks. A response could include a discussion of the activist's record – but only to the extent that it is relevant to the specific claims being made by the activist and otherwise consistent with the corporation's messaging (for example, referring to prior situations where the activist's business proposals generated less value for shareholders can be effective when there is obvious alignment with what an activist is proposing in the current situation; broad-based attacks on an activist's performance (and worse, personality) could be seen as a less compelling corporate response).

By drawing focus to the substance of the activist's proposals (and by being regularly engaged in the review of their business) corporations will be in a good position to seek to either implement the activist measures (entirely or in part) or to demonstrate (publicly) how the implementation has either already been attempted successfully (or unsuccessfully) or otherwise would not be in the best interest of stockholders. The goal should be to make the make the activist's complaints irrelevant without making the situation hostile. In summary, the classic adage "don't attack the activist, make the need for the activist irrelevant" is a good North Star for boards to align toward.

Finally, it is also crucial to continue focusing on the business. Dealing with activist investors can be onerous for a board and management and public campaigns can be messy and expensive thereby easily distracting attention from day-to-day management; this in turn may feed into the activist's narrative and put the corporation further on the defensive.

3. Remedies Available to Shareholders

3.1 Separate Legal Personality of a Company

The US recognises the separate legal personality of a company as distinct from its shareholders. However, the courts are, in rare circumstances, willing to 'pierce the corporate veil'. This will typically occur where a plaintiff proves that the parent company completely controlled its subsidiary and that it would be just to pierce the corporate veil (the 'Alter Ego Theory'). Some jurisdictions, such as Delaware, additionally require the plaintiff to show that the corporate structure was being used to perpetrate a fraud on them. The corporate veil can also be pieced where the plaintiff proves that the subsidiary was acting as the parent company's agent (the 'Agency Theory'). The burden of proof for both of these theories is on the plaintiff and save for exceptional circumstances, the US courts are generally inclined to recognise a company's separate legal personality.

3.2 Legal Remedies Against the Company

Minority and majority stockholders both have the right to bring a direct lawsuit against the company. Many of the claims that a stockholder can bring against a company are established by various sections of the Securities Act and the Exchange Act, a number of which are outlined below.

Under Section 11 of the Securities Act, a stockholder can sue a public company within three years of the public offering of a security if the registration statement contained a material misstatement or omission. There is no need for the plaintiff to show reliance, scienter (the defendant's knowledge that their conduct was wrongful) or loss causation.

Section 12(a)(2) of the Securities Act also provides a remedy for fraud in the offer or sale of securities in the context of a public offering. Much like Section 11, the plaintiff is not required to show reliance, scienter or loss causation.

Section 10(b) of the Exchange Act and SEC Rule 10b-5, in particular, make it unlawful to make untrue or misleading statements or to operate a fraud in relation to purchases or sales of securities. Rule 10b-5 is the basis for many of the class actions brought on behalf of all stockholders who purchased a particular company's shares on the open market. Section 10(b) covers both debt and equity and both private and public securities. However, unlike Sections 11 and 12(a)(2) of the Securities Act, the plaintiff must show scienter, reliance and loss causation.

The Private Securities Litigation Reform Act of 1995 (the 'PSLRA') increased the pleading standard for securities fraud claims. It requires the plaintiff stockholder to identify:

- each allegedly misleading statement and the reason why it is misleading;
- all facts on which the belief is formed; and
- the facts which lead to a "strong inference that the defendant acted with the requisite state of mind".

These requirements have made it more difficult to successfully bring securities fraud claims.

3.3 Legal Remedies Against the Company's Directors

Minority and majority stockholders have the right to sue the company's directors or officers for breaching their statutory or equitable duties. The law in Delaware provides that directors must comply with their duties outlined in the corporate statute of the state of incorporation (ie, the DGCL), the corporation's articles or certificate of incorporation and the corporation's by-laws. Directors must also act in accordance with their fiduciary duties to the corporation and its stockholders. If a director breaches these duties, a stockholder is able to sue them.

A director's two core fiduciary duties are to be fully informed and act with due care (the 'duty of care') and to act in the best interest of the corporation (the 'duty of loyalty').

The duty of care requires directors to act with the level of care expected of an ordinarily careful and prudent person. Notwithstanding this duty, the US courts, in particular those in Delaware, are strong defenders of a director's right to take reasonable business risks. In order to protect this right, the courts generally apply the 'business judgment rule', which creates a presumption that a director in question complied with their duty of care.

The duty of loyalty requires directors to protect the interests of the corporation and avoid conduct that would harm the corporation and its stockholders. A typical example of a breach of the duty of loyalty is when a director usurps a corporate opportunity for their own gain.

The business judgment rule will be applied in most cases concerning a director's fiduciary duties, except those cases alleging that the director breached their duty of loyalty as a result of a conflict of interest. Where the business judgment rule does apply, a plaintiff stockholder is required to prove that the director failed to stay informed, act in good faith or take action in the best interests of the corporation, in order to dispel this rule.

In addition to the duties outlined above, directors may also need to comply with additional legislation, such as the Securities Act and the Exchange Act. Section 15 of the Securities Act and Section 20(a) of the Exchange Act imposes liability on controlling persons (such as directors) for various misrepresentations and fraud regarding the purchase or sale of securities. This serves as another basis on which stockholders can sue a company's directors.

3.4 Legal Remedies Against Other Shareholders

If a stockholder owns a majority interest in a corporation, or otherwise exercises control over its affairs, they will owe fiduciary duties to the company and its minority stockholders.

Section 15 of the Securities Act provides a direct right of action for minority stockholders against controlling stockholders of companies which breach, among others, Sections 11 or 12 of the Securities Act. However, the controlling stockholder will not be liable if they had no knowledge of, nor any reasonable grounds to know of, the breach.

Similarly, Section 20(a) of the Exchange Act provides a right of action against controlling stockholders of companies which breach, among others, Section 10 and Rule 10b-5 of the Exchange Act. However, the controlling stockholder will not be liable if they acted in good faith and did not induce the acts on which liability is founded.

If the controlling stockholder is held to be liable under the Securities Act or Exchange Act, their liability will be joint and several with the company's.

In addition, under Delaware law, controlling Stockholders can owe fiduciary duties to minority stockholders with respect to related-party transaction. Controlling stockholder transactions are generally subject to heightened 'entire fairness' scrutiny, and not the deferential business judgment rule review. This is true whether or not the transaction is a merger/extraordinary transaction.

Unlike independent director approval of related-party transactions that do not involve a controlling stockholder, the corporation cannot have the business judgment rule apply simply by having independent directors approve the transaction. Under the entire fairness standard, controlling stockholders generally bear the burden of proving the entire fairness - ie, that both the price and the process were fare.

However, under the MFW line of cases (Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014) and its progeny), if a transaction has been approved by the affirmative recommendation of a sufficiently authorised board committee composed of independent and disinterested directors and the affirmative vote of a majority of the shares owned by stockholders who are not affiliated with the controller, then the controller has sufficiently disabled itself such that it no longer stands on both sides of the transaction, thereby making the business judgment rule the operative standard of review. If only one of those criteria is met, then the burden is shifted to the plaintiff to show that the transaction was not entirely fair, but the business judgment rule will not apply.

3.5 Legal Remedies Against Auditors

While minority and majority stockholders can theoretically sue a company's auditors or other advisers, it is very difficult to establish primary liability of such actors under the Securities Act or Exchange Act because they normally only review, rather than produce, company documents. Janus Capital Group v First Derivative Traders (564 US 135, 146 (2011)) held that primary liability can only be established if the actor in question has 'ultimate authority' over a statement's content and communication. Furthermore, a number of Supreme Court cases have also reduced the scope for bringing secondary liability claims against actors who assist a corporation. For example, Central Bank of Denver, N.A. v First Interstate Bank of Denver, N.A. (511 US 164 (1994)) held that stockholders could not sue mere 'aiders and abettors' of securities laws violations.

These cases, along with the higher pleading standards which the PSLRA imposed, have been responsible for a rapid decline in auditor litigation in the US. The percentage of claims against auditors under Rule 10b-5 and Section 11 of the Securities Act which have been dismissed has rapidly increased in recent years. For example, the dismissal rate was 23% between 1996 and 1998, but rose to 74% between 2011 and 2013. Similarly, the percentage of non-zero settlements paid by auditors declined from 70% to 35% during those time periods.

3.6 Derivative Actions

Stockholders can bring derivative actions on behalf of the company. While the stockholder will be listed as the plaintiff, the claim belongs to the company. If the derivative action is successful, the defendant may have to pay compensatory and punitive damages to the company or the court may award equitable relief, such as an injunction, to the company. Because of the fact that the stockholder makes the claim, but the company receives the benefit of the claim, derivative actions are an exception to the general rule in the US that the losing party is not required to pay the winning party's legal fees.

In order to bring a derivative action, the plaintiff must be a stockholder at the time the lawsuit is filed and throughout the course of the litigation. The plaintiff must also properly represent the other stockholders. In order to prove that they are representative, the plaintiff must show that they can properly prosecute the derivative action and that their financial interests are not misaligned from those of the other stockholders.

Before filing a derivative action, the stockholder must ordinarily make a written pre-suit demand on the company's board to pursue a legal claim, outlining the nature of the harm and the relief they want the company to seek. Upon making the demand, the board will typically appoint a special litigation committee to investigate the underlying facts and to recommend a response for the board to take. If the board accepts the pre-suit demand, the board will manage the litigation process. If the board reject it, the business judgment rule will apply. There must therefore be reasonable doubt that the rejection was made in bad faith or was grossly negligent in order to dispel the presumption of the business judgment rule and allow the stockholder to bring a derivative action.

The stockholder does not need to make a written pre-suit demand if they can show that making the demand would be futile. Given the difficulty in dispelling the business judgment rule, stockholders often make the futility argument in the first instance and only make a written pre-suit demand if their futility argument is unsuccessful. To prove futility, the stockholder must show a reasonable doubt that the majority of directors were not disinterested in the action, independent in the action or exercising valid business judgment.

3.7 Strategic Factors in Shareholder Litigation

A fall in a company's share price, caused by a specific and identifiable event, is often a catalyst for stockholders to sue their company. While the merits of the case will undoubtedly be a key factor when determining whether to commence litigation, stockholders are likely to attach significant weight to a number of more practical considerations. For example, if the claims are particularly damaging to the reputation of a company and its board, the company may be more willing to offer a significant sum to settle the case early-on, rather than face a protracted and public dispute in court. Conversely, if the company and its directors have limited cash reserves and litigation insurance, stockholders may be deterred from bringing a claim, however strong the merits of the case.

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