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CONSIDERATIONS IN CARVE-OUT TRANSACTIONS

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A notable feature of the 2019 deal-making environment is the significant number of carve-out transactions that have been executed. These transactions have involved many different structures, from divestitures of entire business segments to sales of single brands. The unifying theme of these diverse structures is, of course, that they involve the "carve-out" of a business from a larger going concern. This article focuses on the unique, multifaceted and often intertwined issues that arise in planning and executing carve-out transactions.

General Considerations

Why a Carve-Out?

Broadly speaking, carve-out transactions fall into one of two buckets. The first group could be termed "regulatory divestitures." In this context parties to a pending business combination agree, either proactively or reactively, to divest assets in order to assuage regulatory concerns about the effects of the pending business combination on competition. In antitrust parlance these carve-outs are referred to as "structural remedies" for addressing competition concerns. The second group, which is the primary focus of this article, could be termed "commercial divestitures." Commercial considerations, whether strategic or financial, are the primary motive for these carve-outs. For instance, in the course of reviewing its portfolio of businesses, a company might identify business lines or products that are "non-core" to strategy, under-resourced, or less competitive than its other offerings. One alternative for these assets is to divest them and put the sale proceeds to better use, whether through new investment in "core" assets, R&D, deleveraging, or returning capital to stockholders. Commercial divestitures were, for example, a key strategy of General Electric Co. under the leadership of Jack Welch. Mr. Welch famously employed the slogan that if a GE business was not first or second in its market, then GE would either have to "fix it, close it or sell it." And sell it they did: GE sold 71 businesses during Mr. Welch's first two years at the helm alone.[1] Another alternative for such assets is to spin them off. We will touch briefly on this alternative later in this article as well.

Notably, a commercial divestiture is not always the brain-child of a corporate decision-maker. The call that a public company divest a

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business line or break-up entirely, whether through one or more sales or spin-offs, is a familiar refrain of the stockholder activist. In fact a break-up or divestiture was the activist's thesis in 28% of M&A-driven activist campaigns launched in 2018.[2]

Defining the Business To Be Carved Out

Unlike the sale of a whole company, in which the buyer acquires each and every asset (and liability) of a going concern, the asset and liability perimeter of a carve-out transaction needs to be defined with particularity. In a commercial divestiture of any meaningful scale, however, it would be virtually impossible to list every single asset to be transferred and liability to be assumed. Accordingly, the first step in any carve-out is to craft a workable definition of the business to be sold. This step is critical from both a commercial perspective and a legal one. From a commercial standpoint a clear understanding of the business to be sold avoids any ambiguity in planning and allows clear and coherent analysis and messaging of the transaction. From a legal perspective a clear definition of the business being sold is vital to ensuring the envisaged transaction is documented accurately and efficiently.

At a more granular level, the definition of the business shapes the perimeter of the carve-out by providing the reference point for identifying those assets that are to be included in the divestiture. A seller, wishing to retain all assets used in its other businesses, will typically propose to limit the assets being transferred in the carve-out to those "exclusively" related to the carved-out business. A buyer, by contrast, will be motivated by the opposite concern and want to acquire all assets of the seller "related" to the carved-out business. A common middle-ground is to agree upon a "primarily" related standard for defining the universe of carved-out assets and negotiating tailored treatments for asset categories for which this general standard is not appropriate. Given these competing interests, one can see why a shorthand or vague definition of the business to be sold can be a rich source for future disputes between principals over which assets are "in" or "out" of the transaction. Accordingly, close and careful coordination between businesspeople and counsel is integral to aligning on an appropriately detailed and comprehensive definition of the business to be sold.

On the liability side, a typical seller will want the buyer to assume all historic liabilities of the defined business. On this view the transfer of ownership of the business means that the seller should have a "clean break" from such historic liabilities. A buyer, by contrast, will often take the position that the seller should retain all historic liabilities on the basis that they arose

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under the seller's "watch." This negotiation should be considered in the context of the legal structure of the transaction. When a buyer acquires a legal entity as part of the carve-out, all liabilities of that legal entity travel with it as a matter of law, regardless of the nature of those liabilities. Accordingly, careful due diligence is required whenever "mixed-use" entities are acquired to ensure that any legacy liabilities associated with historic operations are not of concern or are appropriately insured or indemnified. If the seller agrees to remain on the hook for any historic liabilities of a transferred entity, the seller will need to indemnify the buyer as and when such liabilities become due. The value of any such indemnity will depend on the creditworthiness of the indemnitor. When, by contrast, the carve-out is structured as a sale of assets, the buyer does not assume any liabilities that it does not contractually agree to take on (subject to the state law doctrine of successor liability). In either scenario, the ability to allocate historic liabilities in deal documents provides room for creativity and can be a key value point, particularly in view of the information asymmetries between buyers and sellers.

Financial Statements

The process for preparing carve-out financial statements goes hand-in-hand with defining the business to be sold. Sellers should be mindful that the preparation of these financials can be a significant undertaking. Difficult judgments may be needed on the right approach to allocating liabilities or shared assets and how to appropriately present the revenues and costs of doing business on a carve-out basis. A buyer's ability to review carve-out financials is an important component of a fulsome and complete buyer due diligence process. For example, liabilities that are not recorded in the ultimate parent company's consolidated balance sheet because of GAAP materiality determinations may need to be recorded in the carve-out balance sheet.

For a public company considering a carve-out sale, the company's existing independent auditor is a natural candidate to support preparation of the carve-out financials. But the carve-out financials do not necessarily need to be audited. In fact, a seller may prefer to avoid the time and expense involved in an audit process. Many smaller carve-out deals are executed on the basis of unaudited carve-out financials. Purely as a due diligence matter buyers will prefer receiving audited financials in view of the comfort added by the audit process. In addition, when a buyer plans to rely on third party debt financing to fund the planned acquisition—whether bank or bond—audited carve-out financials may be necessary. Moreover, in the case of a U.S. public company buyer, Rule 3-05 of Regulation S-X generally requires such a buyer to provide separate audited annual and unaudited interim pre-acquisition financial statements of the business being acquired where the carved-out business meets specified acquisition significance thresholds. The number of years of historic financial information that must be provided depends on the relative significance of the acquired business to the buyer.[3]

Another topic of negotiation is the level of cooperation that the seller is to provide in the preparation of additional financial statements between signing and closing; this negotiation is often framed by the financial information that is needed for buyer's debt financing. The buyer may also seek a commitment from the seller to make the appropriate seller personnel available for due diligence sessions, lender presentations, road shows, and other miscellaneous calls and meetings in connection with the arrangement of buyer's debt financing for the carve-out.

Sellers are also expected to provide various representations and warranties about the carve-out financial statements in the definitive sale agreement. These representations and warranties will address matters such as confirmation the financials were prepared in accordance with seller's books and records, accurately present the financial condition and operating results of the carved-out business, and reflect or adequately reserve for material liabilities. Traditionally a seller would agree to indemnify the buyer for any losses arising from an inaccuracy in these representations and warranties (subject to agreed-upon baskets and caps). But in the

current market, buyers in carve-out deals are expected to rely on a representations and warranties insurance policy as their sole recourse for losses arising from all but the most fundamental representations and warranties.

Legal Structure

Another consideration is the legal structure by which the carved-out business will be conveyed to the buyer. Common structures include a direct asset sale, a sale of the entities that own transferred assets, or a mix of the two. More exotic structures, such as a reverse Morris Trust, are sometimes utilized when specific tax objectives are sought.

In carve-outs structured as a straight equity sale, all contracts of the transferred entity or entities will travel with them as a matter of law when they are sold to the buyer. Accordingly, the contracts to which these transferred entities are party will need to be reviewed to confirm whether they include a provision that affords certain rights to the counter-party upon a change of control. Common examples of such rights include a right to be provided with advance notice of the change of control and, sometimes, a right to terminate the contract at the counterparty's option. In a direct asset sale structure, whenever the consent of a contractual counterparty is required before the contract can be assigned, the contract cannot be conveyed to the buyer at all until such consent is obtained. Appropriate contractual due diligence is therefore necessary to understand the interplay between the structure of the carve-out and existing commercial agreements.

Purchase Price Elements

Carve-out transactions are typically priced on a cash-free and debt-free basis. In theory, this means that any cash or cash equivalents delivered with the carved-out business will result in an upward adjustment to the purchase price. Conversely, any debt assumed with the carved-out business will result in a downward adjustment to the purchase price. Practice is more complicated, however, as parties often seek to negotiate over which "cash-like" and "debt-like" items should appropriately result in purchase price adjustments.

Another purchase price element in carve-out transactions is working capital. In a carve-out, sellers typically agree to deliver the business with a "normalized" level of working capital. Any shortfall or surplus relative to this normalized peg results in a purchase price adjustment. Because a carved-out business lacks a standalone operating history, however, triangulating a normalized level of working capital can be challenging in practice. The parties should also align on the accounting principles to be used in calculating any working capital surplus or shortfall.

Separation Planning Considerations

Separation Framework

The carve-out of a business from a going concern presents meaningful separation complexities. Ideally, from a separation planning standpoint, the carved-out business would already be operating structurally and commercially on a standalone basis, with its own IT architecture, real estate footprint and allocated personnel. In practice, however, this is rarely the case; IT architecture is often comingled, shared sites are common, and employees often split their time among the seller's various businesses. It is particularly common for vendors to be under contract to provide goods or services to both the carved-out business and the seller's other remaining businesses. In order to thoughtfully carve-out these arrangements the seller's contract management team must, as an initial step, identify these shared agreements. Once the shared contracts are mapped, proposed transfer strategies (such as splitting or subcontracting) need to be assigned by commercial personnel with appropriate functional expertise. At this point counsel will then need to assess whether the counter-party has a consent right over the proposed transfer. When consent is required in this context vendors often seek to negotiate significant concessions. Such transaction costs need to be taken into account by the buyer and its financial advisors for modeling purposes. For this reason buyers regularly insist on full

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visibility into the seller's separation plan prior to signing. The inability of a seller to efficiently and confidently provide this visibility will raise questions about feasibility and cost of execution. A sensible transaction timeline should, therefore, build in an appropriate buffer for thorough separation planning.

In order to obtain additional comfort on the seller's separation plan, a buyer will often require the seller to represent that the assets being sold are "sufficient" for the buyer to continue operating the carved-out business in the ordinary course on a standalone basis. This representation is typically tested against a negotiated benchmark, such as the manner the carved-out business was operated by the seller the moment before the carve-out was completed or in the year leading to completion. Before agreeing to provide a "sufficiency" representation a seller is well-advised to engage in granular separation planning to identify in detail how the carved-out business is to be unwound from the seller's existing operations.

At a more general level, the process of splitting and migrating assets in a carve-out is sometimes memorialized in a formal reorganization plan. Such a plan is designed to neatly package the carved-out business for sale. The terms of such a plan will vary based on the circumstances, but it will often include maps for migrating retained assets out of entities to be sold (so-called "reverse carve-outs") and vice versa. The reorganization documents should track the terms of the definitive sale agreement to ensure that the carved-out business is indeed being properly migrated. The reorganization should also be appropriately documented from a corporate approvals perspective; it is not unusual for an omnibus form of written consent to the reorganization be adopted by the governing bodies of each of the seller-affiliated entities involved.

Intercompany Arrangements

The process of identifying shared third-party dependencies is only one side of the separation planning coin. The other side is mapping any intercompany arrangements in place between the seller and the carved-out business. As one example, the seller may operate a factory that produces an input used in multiple seller business lines, including the carved-out business. Such intercompany arrangements are typical and, for this reason, one or more commercial agreements between the seller and carved-out business will often be put in place at transaction closing. Another frequent interdependency is credit support. Often a seller, as the most credit-worthy entity in a broader organization, provides payment and performance guaranties or deposits on behalf of the carved-out business. These support arrangements will need to be identified and replaced by the buyer in the carve-out. When a buyer is unable to replace the credit support arrangements a seller typically requires special indemnity as recourse in the event such support arrangements are utilized post-closing.

Transition Services Agreements

As outlined above, a carved-out business is often deeply engrained in a seller's corporate infrastructure. For this reason it will typically be impossible for a carved-out business to be ready to function as a truly standalone unit as soon as the transaction is completed. This is especially likely when the buyer is a financial sponsor that lacks an existing platform to integrate the carved-out business into. While a seller may prefer to achieve a "clean-break" with the carved out business, a seller's commitment to provide "transition services" to give the buyer time to build-out or source missing infrastructure is often key to the buyer's underwriting process and a critical element of a complete separation framework.

Careful commercial due diligence is needed to identify which transition services are required and the duration over which they should be provided. Often the individuals needed to identify and define the transition services will be the personnel involved in, and transferred with, the carved-out business. Sellers should be mindful of this fact, since such employees may naturally have goals or loyalties that diverge from the seller. The buyer and seller should also plan for the contingency of identifying additional services that are needed on a

transitional basis that were overlooked during initial separation planning. One approach to addressing these oversights is to align on a framework for negotiating transition arrangements for the omitted services. Another approach is for the buyer to make an indemnity claim under the "sufficiency" representation, which we described above, and use the proceeds of the claim to obtain replacement services.

As with any commercial agreement, the buyer and the seller will need to align on fundamental topics such as the level of care and quality with which the transition services will be provided and the remedies that will be available if these commitments are not met. Sellers will often seek to cap damages at the amount of fees paid by the buyer for the transition services (or some multiple thereof) and exclude any recovery for consequential damages.

Pricing transition services is another matter for negotiation. In the commercial divestiture context, in order to ensure the buyer has an appropriate economic incentive to implement alternatives to the transition services, pricing for transition services often escalates if the buyer wishes to extend the transition services beyond the initial agreed term. A concerned seller can also implement other measures to help ensure the buyer ceases using the transition services in a timely fashion, including requiring the buyer to develop and implement an appropriately detailed transition plan.

The form of agreement governing the provision of transition services is typically fully negotiated at signing and appended to the definitive sale agreement. When this is not possible due to timing or other considerations, the buyer and seller can align on a term-sheet at the time of transaction announcement and finalize a complete transition services agreement between signing and closing of the carve-out. This approach is, however, a distinctly second-best alternative to having a fully negotiated transition services agreement in hand at signing as it may gloss over unrecognized and important points of difference between the buyer and seller.

Employee Matters

In any carve-out the buyer and seller must determine which employees will remain with the seller and which will be transferred with the carved-out business. At bottom, a buyer will want comfort that it is getting the employees needed to run and support the business on "day one." This can be difficult to assess. In large organizations, for example, it is common for a significant employee population to be only partly dedicated to the carved-out business. The challenge of ensuring the right employee population will be transferring is magnified for a buyer, such as a financial sponsor, that lacks an existing employee base. The opposite is often true for large strategic acquirers; these buyers will have a well-established personnel base and may not wish to take the full employee population the seller envisions transferring. If the transaction will result in significant redundancies then obligations arising under labor laws should be front of mind. In addition to agreeing on the universe of transferred employees the buyer and seller will also need to allocate responsibility for any obligations, such as severance payments, arising in connection with employee transfers in the transaction.

It is often difficult to predict how employees affected by a carve-out will react to the deal announcement. For this reason the retention of employees is something that buyers and sellers are wise to consider prior to signing a definitive sale agreement. The parties can work together to develop appropriate retention packages, such as a stay bonus program, to incentivize key employees to remain with the carved-out business until transaction closing. As additional protection against attrition, the seller will often require the buyer to commit to maintain the salary, benefits and bonus opportunity of the affected employee population for some period post-closing. The duration of this commitment and its precise terms are often the subject of extensive negotiation. In our experience, the best outcomes are achieved when in-house HR and benefits experts work closely with external counsel in negotiating an appropriate package.

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Real Estate Matters

Another separation issue in carve-out transactions is addressing the physical space that the carved-out business operates in. Because carved-out businesses generally do not operate on a structurally standalone basis, there is often not a clear division of real property as between the carved-out business and the seller's other business units. Multiple segments may use different production lines in a seller-owned factory or share office space, for instance. While the most straightforward solution from the seller's standpoint may be to simply require the buyer to take full responsibility for addressing the space needs of the carved-out business, this approach can be a major source of business disruption and could create valuation issues. Accordingly, buyers and sellers often try to devise more cooperative solutions. When the carved-out business shares space with retained seller operations under a common lease, for example, the parties may align on a commercial subleasing arrangement. If the carved-out business operates on land owned by the seller, lease arrangements or partial title transfers could be considered. Each solution poses its own complexities, from day-to-day issues like ensuring appropriate information barriers are in place at shared sites, to liability allocation issues if a site with environmental liabilities is being divided.

Additional Considerations

Post-Closing Covenants

Buyers in carve-out transactions often try to bind sellers to various restrictive covenants that apply after the deal has closed to help ensure they receive the benefit of their bargain. One such commitment is the non-compete covenant, which requires a seller not to compete with the carved-out business for a specified period of time. This covenant is meant to protect the buyer from acquiring a so-called "pig-in-a-poke"; the theory is that the value of what the buyer is purchasing would be diminished or even destroyed if the seller could immediately use its resources, know-how and relationships to replicate the carved-out business right after it has been sold. Defining which competitive activities will be prohibited is often the subject of involved negotiation, particularly in respect of actions that are not overtly competitive.

Another post-closing commitment commonly sought by buyers is a "no-poach" or "non-solicitation" covenant. This covenant restricts the seller from soliciting or rehiring employees that are transferred with the carved-out business. In this context, buyers take the view that the talent of the carved-out business employee base is a key asset being acquired. As a compromise, sellers often seek exceptions to a no-poach covenant, such as the ability to re-hire employees of the carved-out business who respond to general (non-targeted) employment solicitations or who are made redundant by the buyer.

It is important that antitrust counsel review both the scope and duration of any non-compete or no-poach covenants being agreed to so as to ensure they would not be viewed by enforcement authorities as impermissible restraints on trade.

Carve-Outs in Heavily Regulated Industries

In heavily regulated industries, such as the financial services sector, a key asset of the carved-out business will be the licenses and permits it possesses. When the carve-out will not simply be a bolt-on for a buyer that already operates with all required licenses, the buyer will often prefer to acquire licensed entities when possible. This is because a licensing change-of-control proceeding is often less onerous and time-consuming than applying for a license from scratch. The licensed entity will be already familiar with the regulatory authority whereas the buyer could be a relative unknown. When change-of-control proceedings or new licenses are required in connection with a carve-out, counsel with appropriate expertise can be a valuable aid in navigating the regulatory process. If the transaction involves a significant number of such proceedings and licenses, it may be prudent for the buyer and seller to prepare a regulatory transition plan. Such a plan typically sets out, on a license-by-license basis, key mile-

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stones and protocols for completing the regulatory process.

Cross-Border Issues

The global carve-out is perhaps the most complex form of divestiture to execute. From a legal standpoint, each jurisdiction within the transaction perimeter can introduce its own particularities. These could take the form of additional regulatory frameworks to be complied with, requirements to inform or consult with local employee representatives, or technical legal requirements to be observed in order to properly transfer entities or assets. Close coordination among country counsel is essential to achieving seamless legal execution of a global carve-out.

Where local legal requirements are such that closing in one jurisdiction is not feasible (or legally permissible) until a meaningfully later date than the other jurisdictions within the transaction perimeter, parties sometimes agree to complete a "staggered closing." In a staggered closing, the carve-out of the business in some countries is completed in advance of the transaction closing in other countries. This permits the earlier realization of a portion of the deal synergies (in the case of the buyer) and the transaction proceeds (in the case of the seller). A staggered closing requires meticulous planning from both a commercial and legal perspective. When a staggered closing is seen as a meaningful possibility, the mechanics for completion should be detailed in the definitive sale agreement. The mechanics should address various contingencies, including a situation in which the delayed closing jurisdictions fail to ever close because required local approvals are ultimately not obtained.

The Spin-Off Alternative

As an alternative to selling a business to a third-party in a commercial divestiture, a company can also unlock value for stockholders by separating the business via a spin-off. At the most basic level, a spin-off involves a company—often termed the "DistributingCo"—packaging a business into a subsidiary—a so-called "SpinCo"—and then distributing the shares of SpinCo to stockholders pro rata in accordance with their stock ownership. Spin-offs can be attractive for a number of reasons. For instance, the equity markets might value SpinCo's assets more attractively as a "pure play" investment opportunity. SpinCo's management might also benefit from the opportunity to define SpinCo's focus and strategy independently from the competing priorities and resource demands of operating in a larger organization with multiple businesses.

A spin-off presents many of the same complexities we have outlined in the context of commercial divestitures, from defining the business to be spun-off to the nuts-and-bolts process of separating that business from a broader enterprise. But spin-offs also present their own special considerations. For one thing, highly involved rules and regulations govern the tax treatment of spin-offs. In order to ensure a spin-off can be structured an executed in a manner that is "tax free" to both the entities involved and stockholders, tax counsel should be consulted early in the planning process. On the securities side, a Form 10 registration statement will need to be prepared and disseminated to stockholders in conjunction with the spin-off. Lastly, multiple ancillary agreements will need to be put in place between DistributingCo and SpinCo to memorialize terms that would be addressed in the definitive sale agreement in a commercial divestiture context, such as allocating responsibility for historic liabilities of SpinCo.

Conclusion

While the issues we have discussed in this article are what make carve-outs uniquely challenging, they are also what make them one of the most rewarding transaction types to complete. Thoughtful and careful planning by dealmakers in anticipating and addressing these matters can help achieve smooth deal execution for all involved.

ENDNOTES:

[1]*See* Joe Nocera, *Was Jack Welch Really That*

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Good? Business Week (Jun. 14, 2019).

[2]*See* Lazard Shareholder Advisory Group 2018 Review of Shareholder Activism (Jan. 2019) *available at* https://www.lazard.com/media/450805/lazards-2018-review-of-shareholder-activism.pdf.

[3]*See generally* Sullivan & Cromwell LLP, Financial Disclosures About Acquired and Disposed Businesses (May 8, 2019), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Financial-Disclosures-About-Acquired-and-Disposed-Businesses.pdf.

FTC FINDS CONSUMMATED MERGER ANTICOMPETITIVE, ORDERS ASSETS TO BE DIVESTED

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On November 6, 2019, the Federal Trade Commission unanimously found that the consummated merger of two sellers of prosthetic knees violated United States antitrust law, ordering the purchaser to divest completely the acquired assets to an FTC-approved buyer.

The case is notable because the transaction was not reportable under the Hart-Scott-Rodino ("HSR") Act, but the FTC nevertheless reviewed the deal subsequent to closing and found it to be anticompetitive. The Commission's decision serves as another reminder that the antitrust agencies have the authority to review transactions that are not subject to filing under the HSR Act and that the buyer can be subject to post-closing remedies including complete divestiture.

The HSR Act's Reporting Requirements

The HSR Act requires that parties to certain mergers and acquisitions make filings with the DOJ and FTC prior to the consummation of these transactions. The HSR filing contains information regarding the nature of the proposed transaction, the revenues and subsidiaries of the parties, and certain kinds of business documents (commonly called "4(c) documents") that provide information related to the competitive effects of the transaction, relative market shares, and synergies.

The HSR Act requires parties to observe a 30-day waiting period after they submit the HSR filings, during which the relevant agency may review the proposed transaction. In some cases, the agency requests additional information from the parties (often called a "second request"), which extends the waiting period. The parties cannot consummate the transaction until the waiting period expires.

Importantly, however, if the transaction is valued at less than $90 million (2019 threshold) or one of a number of exemptions apply, no filing is required and the parties are free to close their transaction.

The Transaction

On September 22, 2017, Otto Bock HealthCare North America, Inc., a manufacturer and seller of prosthetic knees that integrate microprocessors, or MPKs, acquired FIH Group Holdings, LLC (also known as Freedom), which also manufactures and sells lower leg MPKs, among other products. Prior to the acquisition, the firms were the first and third largest manufactures of MPKs in the U.S. by revenue, and, according to the FTC, "competed vigorously against each other on both price and innovation."[1] Indeed, according to the complaint, the consummation of the transaction brought Otto Bock's market share in the all-MPK relevant market to over 80%.[2] Shortly after closing the deal Otto Bock issued a press release announcing the benefits of the deal, stating "[t]ogether, [Otto Bock] and Freedom Innovations—the number one and the number three on the American market—will benefit from their combined sales power and portfolios."[3]

What Happened?

Two months after the acquisition closed, the FTC is-

sued an administrative complaint challenging the transaction, specifically asserting that the merger violated Section 5 of the FTC Act and Section 7 of the Clayton Act. In the complaint, the FTC alleged that the merger "harmed competition in the U.S. market for microprocessor prosthetic knees by eliminating head-to-head competition between two companies, removing a significant and disruptive competitor, and entrenching Otto Bock's position as the dominant supplier."[4] On the day before the FTC filed the Complaint, Otto Bock entered into a Hold Separate and Asset Maintenance Agreement with the FTC and proposed a divestiture in an attempt to allay the FTC's concerns.[5] As administrative proceedings continued, Otto Bock put forth a number of affirmative defenses, and claimed the proposed divestiture would address any anticompetitive effect in the MPK industry.

An Administrative Law Judge found that the merger violated antitrust law in a decision issued on April 29, 2019. There, it held that Otto Bock's high market share, coupled with the resulting elimination of competition between Otto Bock and Freedom, proved a reasonable likelihood of anticompetitive effects in the relevant MPK market. Regarding the proposed divestiture, the ALJ found it to be too speculative and lacking in necessary terms to properly evaluate whether it would sufficiently counteract any anticompetitive effects.[6]

On November 6, 2019, more than two years after the deal closed, the Commission unanimously upheld the ALJ's decision. In its decision, the Commission pointed to the highly concentrated market, and evidence from clinical customers that viewed Otto Bock and Freedom's products as their first and second choice prior to the merger. It also cited evidence that the companies vigorously competed against each other prior to the pre-merger, as well as evidence of Otto Bock's intent to raise prices on the companies' products after the acquisition.[7] The Commission also determined that, because the proposed divestiture was only brought up after the consummation of the acquisition, it could not be considered as part of the challenged transaction, and thus would not impact its decision on whether the transaction violated the antitrust laws.[8] The Commission did consider the proposed divestiture as part of its remedy analysis, but found that it was inadequate for a variety of reasons. As a result, the Commission ordered Otto Bock to "divest Freedom's entire business" with limited exceptions.[9]

Takeaways

- **Transactions in which HSR filings are not required may come to the attention of the agencies through other means.** The Otto Bock-Freedom transaction was not subject to HSR filing, but nonetheless became subject of FTC investigation and an adverse decision after its consummation. The agencies may become aware of a non-reportable transaction in a variety of ways, including customer complaints and routine internet searches that return press releases and articles.

- **Non-reportable transactions may be subject to post-closing investigation and action.** The Otto Bock-Freedom proceedings were not resolved until more than two years after the consummation of the acquisition. Parties engaged in transactions not subject to HSR filing should be aware that the antitrust agencies may take action if they become aware of an acquisition that is perceived to have anticompetitive effects, that resolution of such issues may take significant periods of time, and that remedies up to and including complete divestiture may be ordered.

- **Divestiture and other mitigation offers will be discounted by the FTC if implemented after the deal is closed.** In other cases, the antitrust agencies and courts have taken into account a proposed divestiture in evaluating whether a transaction—as modified by the divestiture substantially harms competition. This is commonly referred to as "litigating the fix." In this case, however, Otto Bock only proposed the divesture after closing and on the eve of the FTC's challenge. The FTC concluded that such a post-

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closing divestiture cannot be considered in evaluating whether the initial acquisition was legal.

- **HSR "clearance" should still provide comfort.** The Otto Bock-Freedom merger was not reportable under the HSR Act, and was investigated and unwound post-closing. Parties to the vast majority of transactions where there are no or minimal antitrust concerns can still look to HSR "clearance" as a positive milestone in the lifecycle of a transaction.

ENDNOTES:

[1]Opinion of the Commission, *In the Matter of Otto Bock HealthCare North America, Inc*., p. 2 (November 6, 2019)

[2]Complaint, *In the Matter of Otto Bock HealthCare North America, Inc.,* p. 2 (December 20, 2017)

[3]Otto Bock acquires Freedom Innovations, https://insideoandp.com/2017/09/26/ottobock-acquires-freedom-innovations.

[4]Complaint, *In the Matter of Otto Bock HealthCare North America, Inc.*, p. 1 (December 20, 2017).

[5]Opinion of the Commission, *In the Matter of Otto Bock HealthCare North America, Inc.*, p. 9 (December 20, 2017).

[6]Id. at 11.

[7]Id. at 25.

[8]Id. at 51-52.

[9]Id. at 4.

IS UK MERGER CLEARANCE STILL VOLUNTARY?

By Matt Evans

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The short answer is yes, merger clearance in the UK is still voluntary. However, in recent months, the UK Competition and Markets Authority ("CMA") has adopted an increasingly aggressive approach to its investigations, which has led some to question whether a "voluntary" approach to UK merger filings is still warranted. This article explores those developments.

Background on Global Merger Filing Regimes

Today there are more than 130 jurisdictions with merger control regimes, which take a variety of approaches to merger review. Lawyers tend to categorize them as follows:

- Developed economies with mandatory notification that ban closing before clearance. These jurisdictions tend to take priority in merger reviews both because they are mandatory, but also because they have developed various levels of precedent in merger reviews. This list includes the United States, the European Union, China, Japan, and most individual member states of the EU, with the notable exception of the UK.
- Less significant economies with mandatory regimes, but little active enforcement of those regimes.
- Voluntary regimes, of which four merit more than cursory consideration: the UK, Australia, Singapore, and New Zealand.

Deal lawyers and their clients sometimes pay little attention to the voluntary regimes because there is no automatic ban on closing the deal without seeking prior approval. In some cases, trying to avoid a UK review makes sense because even Phase I takes several months. It is not surprising, therefore, that many deals—even some that trigger the UK's filing thresholds—are not notified to the CMA. Historically, this approach has been relatively low risk. But recently, the CMA has asked the UK government to introduce a mandatory notification regime for deals of a certain size. The UK government has not acted on that request, however; in the meantime, the CMA has taken matters into its own hands.

UK Merger Control

The CMA has jurisdiction to review a deal if one of the following tests is met:

1. the target business generated sales to UK cus-

tomers in the previous financial year of more than £70 million; or

2. both the target and the acquiring group of companies purchase or supply the same broadly or narrowly defined category of goods or services in the UK and between them account for 25% or more share of that supply (the "Share of Supply Test"); or

3. the target supplies military or dual-use goods in the UK, quantum computing or computer processing units IP or hardware, in which case the thresholds are lowered to £1 million in UK sales or the target alone having a 25% UK share of supply even if there is no overlap with the buyer.

It is important for companies to understand that the Share of Supply Test is not a market share test. Instead, the CMA has broad discretion to define the goods or services that comprise the share of supply. The nature of the Share of Supply Test means that even if the parties do not see themselves as competitors, the CMA may be able to define a category of goods or services in which they overlap. For example, in a hypothetical merger between an automobile manufacturer and a bicycle manufacturer, it is unlikely that an economic analysis would conclude that cars and bicycles are part of the same relevant market. However, if the combined share in "personal transportation" is more than 25%, the CMA could require a filing. In addition, even if one party only self-supplies and never sells to third parties, the CMA can use those captive sales to find an overlap and assert jurisdiction.

Notification is still "voluntary" meaning that merging parties are free to close their deals without approaching the CMA, even if the parties technically trigger the filing threshold. If parties submit a filing, the CMA has four months from completion of the deal being brought to its attention (for example by being put in the public domain) in which to assert jurisdiction. Where the CMA opens a post-closing review, it immediately prevents the buyer from carrying out any further integration of the merged businesses and from having any oversight into the acquired business. Hold separate arrangements are usually overseen by a third-party monitoring trustee paid for by the buyer but reporting to the CMA.

CMA Flexes Its Muscles

The last 12 months have seen the CMA adopt an aggressive approach to deals, including international deals involving global markets with limited nexus to the UK. Senior CMA officials have described the UK's "voluntary" regime as meaning that shares may be transferred in return for payment but integration should not take place. In particular, the CMA has:

- Used powers to issue initial enforcement orders on international deals permitting the parties to close the deal but then immediately keep them separate (*Roche/Spark*); and

- Ultimately prohibited consummated deals and ordered them to be unwound (*Tobii/Smartbox, Intercontinental Exchange/Trayport* and *Eurotunnel/SeaFrance*).

It is an apparent extension of the use of initial enforcement order powers that is most notable. While the CMA has not previously shied away from issuing initial enforcement orders subjecting merging parties to externally monitored hold separate regimes in transactions that were not notified voluntarily (*e.g.*, *Danspin/Lawton, VTech/LeapFrog, Electro Rent/Test Equipment, Pork Farms/Kerry Foods, Sonoco/Weidenhammer*), it has now also started to use unwinding orders that require parties to reverse entirely lawful integration, prior to CMA's determination of whether the transaction actually gives rise to competition issues that must be addressed.

In a case that is ongoing at the time of writing (*Bottomline/Experian*), prior to even commencing the merger inquiry the CMA had both appointed a Hold Separate Manager to exercise day-to-day management and control of the target business and it issued an

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unwinding order requiring Bottomline to take steps to reverse integration that had occurred to date, including segregation and/or destruction of confidential information received from the target business. In a case from earlier this year, *Tobii/Smartbox*, the CMA issued an unwinding order during the course of its investigation, requiring Tobii and Smartbox to terminate a reseller agreement, and for Smartbox to both reinstate research and development projects that it had ended in addition to accept orders for products it had ceased supplying as a result of the transaction.

Recommended Approach to UK Merger Control

In many cases, it may still be reasonable to decide not to notify deals in the UK. However, buyers of business trading in the UK need to be aware of the CMA's expanding merger enforcement and growing use of orders to halt (or reverse) integration. A decision not to file should be informed and subject to considered analysis. Regardless of whether the parties think they compete or whether they are active in the same economic markets, companies must ask whether there is still a way by which the CMA could assert jurisdiction. If so, you should ask whether it is likely and how should the parties address that risk both with respect to substantive antitrust analysis and the transaction agreement between the parties.

EU MERGER CONTROL REFORM: A LOOK AHEAD TO 2020

By Jay Modrall

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The new European Commission (EC)—after a slight delay—will be up and running in early 2020. For the first time in recent memory, merger control reform is high on the political agenda in the European Union, as in the United States. Calls for reform come from within the EC and from key EU Member States, industry, and commentators. But reform advocates have conflicting objectives.

The most basic tension relates to whether EU merger review should be tougher or more flexible. EU Commissioner Margrethe Vestager is soon to be reappointed with two portfolios—as Competition Commissioner and Commissioner for making Europe fit for the digital age (Digital Commissioner). She and many commentators argue that EU merger control should be tougher, at least in the digital sector. In particular, an April 2019 report by three special advisors (the Digital Era Report)[1] appointed by Commissioner Vestager called for significant changes to EU merger control.

Following the EC's prohibition of the Siemens/Alstom merger in February 2019,[2] by contrast, the French and German governments called for changes to ease approval of some transactions, including notably a process to allow Member States to overrule EC merger prohibitions on public policy grounds.[3] While this controversial proposal has been abandoned, France and Germany, now joined by Poland, continue to press for more flexibility in EU merger review.[4]

This article provides a brief overview of the main reforms proposed on both sides and preliminary thoughts on concrete changes we can expect in the next EC mandate.

Merger Control in the Digital Era

The implications of digitization for merger review has been a key focus for Commissioner Vestager, who approvingly cited the Digital Era Report's proposal to "revisit our theories of harm, so we can intervene in mergers when the owners of ecosystems buy start-ups before they have a chance to grow—strengthening that ecosystem, and helping to protect it from competition." The Digital Era Report focuses on cases in which a dominant platform and/or ecosystem benefitting from strong positive network effects acquires a target with low turnover but a large and/or fast-growing user base and a high future market potential.

Two concerns have commonly been raised in connection with such transactions. First, they may escape review entirely in merger review systems with turnover-based review thresholds, such as the EU's. Although some jurisdictions have introduced transaction-value thresholds to capture such transactions, the Digital Era Report argues that it is too early to change the EU merger regulation's (EUMR's) jurisdictional thresholds, preferring to monitor the impact of such changes in other jurisdictions and the operation of the EUMR's referral system. Nonetheless, Commissioner Vestager has kept the possibility of changing the EUMR thresholds open for now.

Second, when these transactions are reviewed, potential anti-competitive effects may not be identified or be underestimated under the current merger review standards. The Digital Era Report recommends against changes to the EUMR's substantive standard of review, arguing that the current "significant impediment to effective competition" (SIEC) test is adequate. However, the Report argues for a "heightened degree of control" of acquisitions of small start-ups by dominant platforms and/or ecosystems. Where an acquisition is plausibly part of a strategy of preventing partial user defection from the acquiror's ecosystem, the notifying parties should bear the burden of showing that the adverse effects on competition are offset by merger-specific efficiencies. To identify such cases, the Digital Era Report recommends asking the following questions:

- Does the acquirer benefit from barriers to entry linked to network effects or use of data?
- Is the target a potential or actual competitive constraint within the technological/users space or ecosystem?
- Does its elimination increase market power within this space notably through increased barriers to entry?
- If so, is the merger justified by efficiencies?

This change would address a perceived gap in current theories of harm, which have difficulty distinguishing pro-competitive or neutral deals from anti-competitive deals where there is not a substantial horizontal overlap between the "core" market dominated by the acquirer and the separate (but typically related) market served by a start-up, and it may be difficult to prove the existence of potential competition with a sufficient degree of certainty. In a vertical or conglomerate merger, the Digital Era Report notes that established theories of harm are limited to foreclosure effects (where actual or potential rivals' access to supplies or markets is hampered or eliminated as a result of the merger) or to coordinated effects (where the merger significantly raises the likelihood of coordination). In markets characterised by a few large firms with highly entrenched positions of dominance in core markets that serve as focal points for an expanding digital ecosystem, the acquisition of a start-up may strengthen a dominant position in the ecosystem, even if the overlap is not within the more narrowly defined product market where the acquirer is dominant or where the combination would otherwise raise concerns.

The new theory of harm would involve taking a broader view of the incumbent's position in a "market for the digital ecosystem." A finding of an SIEC could be justified, according to the Report, where an acquisition both expands the scope of network effects that protect the incumbent's core service to the complementary services, and "appropriates" the network effects that the target has managed to establish to the benefit of its own customers in such a way that, after the merger, they further strengthen the ecosystem as a whole. Acquirors may use defensive acquisition strategies to expand existing network effects, making their services more valuable to both their users and a target's, but also eliminating the risk that the target attracts away those users. This, and the concomitant raising of barriers to entry by combining the acquirer's and the target's positive network effects, may significantly impede effective competition if, without the merger, the target could have succeeded as a stand-alone business or would realistically have been bought up by another competitor.

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The Digital Era Report argues that this new theory of harm would not raise concerns about legal uncertainty that could arise under other approaches, such as broadening theories of harm based on elimination of potential competition, and reduce the number of false positives. The controversial acquisitions concern start-ups with a fast-growing user base, so the competitive threat is already present. Since it would be necessary to compare the competitive conditions resulting from a notified merger with those that would have prevailed without the merger, however, predictions would still be required, *e.g.*, about whether the target could survive and grow in the market or be acquired by other companies raising fewer concerns.

It is too soon to say whether the Digital Era Report's recommendations will be adopted in future cases. As mentioned, however, Commissioner Vestager speaks approvingly of these recommendations. At a minimum, the EC will doubtless be scrutinizing transactions in which large companies, particularly digital platforms, acquire start-ups or other small companies.

Public Interest and Merger Control

As mentioned, France and Germany reacted angrily to the *Siemens/Alstom* prohibition and proposed a number of changes to EU merger review. They have since abandoned their most controversial proposal, to introduce a mechanism for the European Council to override EC prohibition decisions in "well-defined cases" and "subject to strict conditions." In July 2019, however, the French, German and Polish governments issued a revised proposal entitled Modernising EU Competition Policy. Among other things, France, Germany and Poland propose:

- strengthening the Council's input into policy- and decision-making both at the political and the technical levels;
- evaluating and modernizing current guidelines on the assessment of horizontal mergers and on the definition of relevant markets to introduce more flexibility, better take into account competition at global level and protect strategic common European interests, taking greater account of potential competition and the trade and industrial policy approach of non-EU countries to assess the likelihood of market entry and the future strength of non-EU competitors;
- taking a "clearer position" in regard to the relevant geographic markets, especially in relation to global markets and paying particular attention to competition from non-EU State-backed or subsidised companies;
- taking greater account of third countries' market interventions including via State-controlled entities and subsidies;
- adopting guidelines on the assessment of efficiencies and industry competitiveness, with the aim of strengthening EU competitiveness; and
- encouraging the use of remedies other than divestitures, since such remedies are more flexible.

Taking account of the *Siemens/Alstom* background, the French/German/Polish proposal appears intended to improve the approval prospects for transactions involving or intended to create "European champions." The Franco/German/Polish proposal would give Member States a greater role in the EU merger review process (though no longer a veto); expand the EC's view of geographic markets to give greater weight to competition from non-EU competitors, especially State-controlled or subsidized competitors; revise the substantive assessment of transactions to take greater account of potential competition from State-controlled or subsidized competitors; bring European industrial competitiveness considerations into the review process; and allow greater flexibility when remedies are imposed.

How are these proposals likely to be received? On the one hand, Commissioner Vestager has been steadfast in opposing the politicization of EU merger review. Revising the EUMR or EC internal processes to give Member States specifically and industrial policy argu-

ments more generally a greater role will likely not be well received. Similarly, the EC is unlikely to make significant changes to its approach to defining geographic markets, which it reviewed in 2015. The EC is also likely to resist significant changes to its merger remedy policy, which has long favored structural remedies such as divestitures over more flexible "behavioral" remedies.

On the other hand, the EC can more closely scrutinize the distortive effect of State ownership or subsidization of non-EU competitors in the markets it examines without any changes to the EUMR or the EC's internal rules. Indeed, anecdotal evidence indicates that the EC has already begun doing just that. The EC can also look more closely at whether State-owned or subsidized companies not driven by purely economic objectives may be more likely to enter EU markets.

Similarly, the EC may be open to reviewing its guidelines on assessment of horizontal and non-horizontal mergers, which were adopted in 2004 and 2008, respectively. As part of that process, the EC might update its description of the criteria for assessing notified transactions' impact on potential and innovation competition and the evaluation of efficiencies, subjects on which a great deal of work has been done in recent years. However, any changes in these areas may tend to make EU merger control tougher, along the lines suggested in the Digital Era Report, not more flexible.

What Next?

Change is coming to EU merger control, but the forces for change are pulling in different directions. In her "mission letter" to Commissioner Vestager,[5] the incoming EC President Ursula von der Leyen highlighted merger control reform as a task for Vestager's new mandate but did not highlight specific areas for change.

Commissioner Vestager has steadfastly opposed mixing public policy and merger review. While she is Competition Commissioner, changes to the EUMR or the Commission's internal regulations to introduce industrial policy considerations into EU merger review seem unlikely to make much headway.

On the other hand, Vestager may be open to a number of reforms intended to capture more transactions or to tighten the EC's review process. Commissioner Vestager may reopen the discussion on introducing a deal-size threshold to capture more acquisitions of start-ups with low turnover. While she may be open to revising the EC's merger guidelines, as requested by some Member States, the outcome may not be what they expect. Vestager is sympathetic to the Digital Era Report's call for new theories to tighten the review of start-up acquisitions, especially by online platforms. Vestager may also see a need to update the EC's guidelines in areas where significant decisions have been adopted in recent years, including the assessment of merger efficiencies and innovation competition. Again, any changes in this regard would not necessarily benefit European champions.

Some conflict may be expected at the EC behind the scenes. Notably, without linking EU industrial strategy to EU merger review, von der Leyen's mission letter mentioned the role of competition in EU industrial strategy and instructed Vestager to work with Member States to support "Important Projects of Common European Interest." Another clue to potential internal divides came in late November 2019, when the French Commissioner-designate Thierry Breton called for re-assessment of the rules that led to the prohibition of Siemens/Alstom, even though his mandate will not include EU merger control.

It is difficult to make predictions, especially about the future. But it seems safe to assume that the new EC will make merger control reform a high priority, and change is in the wind.

ENDNOTES:

[1]Jacques Crémer, Yves-Alexandre de Montjoye, and Heike Schweitzer, Competition Policy for the Digital Era, *available at*

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https://ec.europa.eu/competition/publications/reports/kd0419345enn.pdf.

[2]Decision of February 6, 2019, *available at* https://ec.europa.eu/competition/mergers/cases/decisions/m8677_9376_3.pdf.

[3]A Franco-German Manifesto for a European industrial policy fit for the 21st Century, *available at* https://www.bmwi.de/Redaktion/DE/Downloads/F/franco-german-manifesto-for-a-european-industrial-policy.pdf?__blob=publicationFile&v=2.

[4]*Available at* https://www.bmwi.de/Redaktion/DE/Downloads/M-O/modernising-eu-competition-policy.pdf?__blob=publicationFile&v=4.

[5]*Available at* https://ec.europa.eu/commission/sites/beta-political/files/mission-letter-margrethe-vestager_2019_en.pdf.

CORPORATE GOVERNANCE FEATURE: SUMMARY OF CHANGES IN ISS AND GLASS LEWIS VOTING POLICIES FOR THE 2020 PROXY SEASON

By Daniel J. Bursky, Lee T. Barnum, Matthew V. Soran, and Gail Weinstein

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Proxy advisory firms Institutional Shareholder Services Inc. (ISS) and Glass Lewis recently released updates to their respective proxy voting policies and guidelines. The ISS changes generally will apply to shareholder meetings held on or after February 1, 2020; and the Glass Lewis changes generally will apply to shareholder meetings on or after January 1, 2020. We describe the key changes below.

Key Points

Of particular note:

- **Board gender diversity**. ISS will now generally recommend voting against or withholding votes from the chair of the nominating committee (or other directors on a case-by-case basis) at companies with no women on the board.

- **Multi-class structures**. ISS will now generally recommend voting against or withholding votes from the entire board if prior to or in connection with a public offering the company has implemented a multi-class structure with unequal voting rights without a sunset provision that ISS considers reasonable.

- **Shareholder proposals**. Glass Lewis' update reflects the firm's continuing efforts to promote shareholder opportunities to vote on shareholder proposals relating to material matters (particularly relating to "responsible and financially sustainable business practices") even when the shareholder proposal is properly excludable under Rule 14a-8 of the Exchange Act. In response to the SEC's recent announcement that it may decline to take a view or may respond orally to no-action requests for shareholder proposals under Rule 14a-8, Glass Lewis now will generally recommend voting against members of the governance committee if the company omits a shareholder proposal from its proxy statement without having received written no-action relief from the SEC.

ISS Update

Board Gender Diversity. ISS' "transition" policy relating to board gender diversity has now expired. Going forward, ISS will recommend voting against the chair of the nominating committee, or against other directors on a case-by-case basis, at companies that have no women on the board. A "firm commitment" by the company (that is, a plan with measurable goals) to appoint at least one woman to the board within a year will now only be a mitigating factor—and will be a mitigating factor only for 2020. In addition, the update states that a company's having had a woman on the board in the prior year, but not in the current year, will not on its

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own avoid a negative recommendation from ISS. Rather, a company in this situation would also need to provide a "firm commitment" to appoint at least one woman director within one year, and would have to acknowledge the current lack of board gender diversity.

Independent Board Chair Proposals. The update largely codifies the existing ISS policy with respect to independent board chair proposals and affirms that ISS does not require a separation of the CEO and board chair roles or an independent chair. While the update states that ISS will continue to apply a "holistic approach" to evaluating independent board chair proposals, the policy now specifies the factors that will increase the likelihood of ISS recommending support for an independent board chair proposal. Support "will be likely" at companies where (i) a majority of the board is non-independent or non-independent directors serve on key board committees; (ii) there is a "weak or poorly defined lead independent director role that fails to serve as a counterbalance to a combined CEO/chair role"; (iii) there is an executive or non-independent chair in addition to the CEO, or there has been a recent recombination of the CEO and chair roles or a departure from a structure with an independent chair; (iv) there is evidence that the board has failed to oversee and address material risks facing the company; (v) there has been a material governance failure, particularly if the board failed to adequately respond to shareholder concerns or the board materially diminished shareholder rights; or (vi) there is evidence that the board has "failed to interfere when management's interests are contrary to shareholders' interests." The update indicates that ISS will not "ignore" company performance in its evaluation; however, the guidelines no longer include an explicit statement that one-, three-and five-year performance may be a mitigating factor. The ISS Policy FAQ that is expected to be published in early 2020 will include an updated overview of how ISS will analyze the scope and rationale of an independent board chair proposal, the company's current board leadership structure and practices, company performance, and potential "overriding factors."

Newly Public Companies. For increased "clarity," the update creates the following two distinct policies:

- ***Problematic Governance Structures***. For newly listed companies, ISS generally will recommend voting against or withholding votes from the entire board if, without a sunset provision, the company has provided for: (i) supermajority vote requirements to amend the company's organizational documents; (ii) a classified board structure; or (iii) other provisions that are, in ISS' opinion, "egregious." A "reasonable" sunset provision will be viewed as a mitigating factor.

- ***Multi-Class Shares with Unequal Voting Rights***. ISS will now generally recommend voting against or withholding votes from directors of newly public companies if, without a sunset provision, the company has provided for a multi-class capital structure with unequal voting rights among the classes. A "reasonable" time-based sunset provision will be viewed as a mitigating factor. When evaluating the reasonableness of a sunset period, ISS will consider the company's lifespan, its post-IPO ownership structure and the board's disclosed rationale for the specific duration selected. However, no sunset period of more than seven years from the date of the initial public offering will be considered to be reasonable.

Share Buyback Proposals. Most companies implement share repurchase programs through board resolutions without a shareholder vote. In the rare cases where a company seeks shareholder approval for a management proposal to institute a share repurchase plan, ISS generally will recommend voting in favor if the plan is for open-market purchases in which all shareholders may participate on equal terms, or the plan grants the board authority to conduct open-market purchases, *provided* that there are not "company-specific concerns" regarding "abusive practices" such as: (i) greenmail; (ii) using buybacks to inappropriately manipulate incentive compensation metrics; (iii) threats to a company's long-term viability; or (iv) other company-specific fac-

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tors as appropriate. (ISS states that this policy will apply to both U.S. incorporated companies and foreign-incorporated "U.S. Domestic Issuers" that are traded solely on U.S. exchanges.) Also, on a case-by-case basis, ISS will recommend voting in favor of proposals to repurchase shares directly from specified shareholders, after balancing the company's stated rationale for the repurchases against the possibility for "misuse" (such as a repurchase of shares from insiders at a premium to the market price).

Ability of Shareholders to Amend Bylaws. ISS will now oppose management proposals seeking to approve or ratify requirements that exceed those of SEC Rule 14a-8. In addition, ISS will recommend voting against or withholding votes from governance committee members if the bylaws impose, in ISS' opinion, "undue restrictions" on shareholders' ability to amend the bylaws (including as to subject matter restrictions, share ownership and holding period requirements more restrictive than Rule 14as-8, and prohibitions on the submission of binding shareholder proposals)—even if the restrictions were approved by the shareholders.

Exemptions for New Director Nominees. In forming its recommendations for director nominees who have served on the board for less than one year, ISS will consider whether the director should be held responsible for an action that was taken by the board before the director's service began and that ISS disfavors. Also, ISS will exclude from its attendance policy director nominees who have served for only part of the company's fiscal year.

Compensation Programs. ISS' evaluation of equity-based compensation programs will now include "evergreen" features (*i.e.*, automatic share replenishment) as an "overriding factor" that will generally trigger a recommendation to vote against the plan proposal.

Pay-for-Performance. The update confirms that ISS will incorporate the use of Economic Value Added (EVA) metrics into its quantitative pay-for-performance model's secondary Financial Performance Assessment (FPA) screen. An ISS whitepaper detailing the mechanics is expected later this year.

Pay Gap. ISS has added to its existing policy of voting on a case-by-case basis on shareholder proposals requesting reports on pay data by gender that it will also do so with respect to requests for reports on pay data by race or ethnicity. ISS will take into account whether these issues have been the subject of recent controversy, litigation or regulatory action, and whether the company's reporting regarding its pay gap policies or initiatives is lagging its peers.

Glass Lewis Update

Exclusion of Shareholder Proposals. The update reaffirms Glass Lewis' belief that a company should exclude a shareholder proposal from its proxy filings only when the SEC has explicitly concurred with the company's argument that the proposal should be excluded. The update notes the SEC's September 2019 announcement that the SEC Staff now may respond orally (rather than in writing) to certain requests to exclude shareholder proposals or may decline to respond at all, without that indicating a view that the proposal should be included. In response, the update states that Glass Lewis generally will recommend voting against all members of the governance committee when (i) the company has excluded a shareholder proposal and the SEC declined to state a view as to the exclusion of the proposal or (ii) the SEC orally (*i.e.*, "with no written record") granted no-action relief permitting the exclusion and the company did not provide "some disclosure concerning this no-action relief." We note that the SEC Staff has indicated that it will be recording its oral decisions in some form on the SEC website; however, the update does not address whether Glass Lewis will consider that recording to be a "written record" for these purposes.

Supermajority Voting Shareholder Proposals. While Glass Lewis' policies generally are opposed to supermajority voting requirements, in the case of controlled companies Glass Lewis may recommend voting against shareholder proposals to eliminate supermajor-

ity voting requirements on the grounds that supermajority voting requirements can serve to protect the interests of minority shareholders.

Special Meeting Rights Shareholder Proposals. Glass Lewis' update clarifies that it generally will recommend a vote against the chair and/or any member of the governance committee where a company includes a management proposal to ratify an existing special meeting right in order to exclude a shareholder proposal seeking a special meeting right that is "materially different."

Director Attendance. While director absenteeism has in the past been a trigger for Glass Lewis recommending to withhold votes, Glass Lewis now generally will recommend voting against the governance committee chair when (i) directors' attendance records for board and committee meetings are not disclosed, or (ii) when the disclosure indicates that one or more directors attended less than 75% of the meetings but the disclosure is too vague for it to be determined which specific directors' attendance was lacking. We note that, under Item 407(b) of Regulation S-K, companies are already required to disclose the name of each director who attended less than 75% of board or committee meetings.

Audit Fee Disclosure. Glass Lewis will now generally recommend voting against the audit committee chair when a company fails to disclose the audit-related and non-audit-related fees paid to the company's external auditor. We note that, under Item 9 of Schedule 14A, companies are already required to disclose audit-related and non-audit-related fees billed in each of the last two fiscal years by the company's auditor.

Forum Selection Clauses. Glass Lewis will continue generally to recommend a vote against the chair of the governance committee in the year a board adopts a forum selection clause without a shareholder vote. However, Glass Lewis states in the update that it will "evaluate the circumstances surrounding adoption" of a forum selection clause and it "may make an exception to this policy" if the provision "is narrowly crafted to suit the unique circumstances facing the company and/or a reasonable sunset provision is included."

Say-on-Pay Frequency. Glass Lewis now will generally recommend voting against all members of a compensation committee when the board adopts a say-on-pay frequency vote that differs from the frequency approved by a plurality of shareholders. Glass Lewis acknowledges that a shareholder frequency proposal is advisory in nature, but "generally believe[s] such cases are an example of the board ignoring the clear will of the shareholders."

Responsiveness to Low Say-on-Pay Support. The update adds to the list of reasons that Glass Lewis may recommend a negative vote on say-on-pay an "insufficient response" by the company to a low level of shareholder support for say-on-pay in a prior year. The update clarifies that, where 20% or more of shareholders opposed a say-on-pay proposal, it is Glass Lewis' view that the board should demonstrate "some level of engagement and responsiveness to the shareholder concerns behind the discontent," which should "correspond with the level of shareholder opposition, as expressed both through the magnitude of the opposition in a single year, and through the persistence of shareholder discontent over time." In addition, Glass Lewis "expects" a "robust disclosure of engagement activities and specific changes made in response to [the] shareholder feedback"—and it "may consider" recommending against the upcoming say-on-pay proposal absent this disclosure.

Analysis of Executive Employment Arrangements. The update refines Glass Lewis' approach in evaluating executive employment arrangements as follows:

- ***Double-triggers***. The update states that Glass Lewis considers double-trigger change of control provisions (*i.e.*, those that require both a change of control and subsequent termination or constructive termination of employment) to be best practice. Glass Lewis may recommend a negative say-on-pay vote if an arrangement is not "explicitly double-trigger."

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- ***Change of Control Definition***. The update indicates that Glass Lewis will view as problematic overly broad change of control definitions which trigger payments to executives when "no meaningful change in status or duties has occurred."

- ***Correcting Problematic Pay Practices***. The update states that Glass Lewis considers it to be best practice to correct "problematic pay practices"—such as excessive change of control entitlements, modified single-trigger change of control entitlements, excise tax gross-ups, and/or multi-year guaranteed awards—when executive employment agreements are materially amended.

- ***Short-Term Incentives***. The update clarifies that, where a company applies "upward discretion" to a short-term incentive (for example, by lowering performance goals mid-year or increasing potential payouts), Glass Lewis now expects detailed disclosure as to the reasoning behind and necessity of that decision.

Peer Groups. The update indicates that Glass Lewis no longer relies solely on Equilar peer groups when comparing pay for performance across companies. As a result, the makeup of a company's peer group is expected to change, which could affect how a company will be evaluated by Glass Lewis for say-on-pay purposes going forward.

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FROM THE EDITOR

Ring Out the Old, Bring in the New

This is the last issue of *The M&A Lawyer* that will be published in the 2010s. It's hard to believe that we've made it through another decade, one that's been marked by generally strong M&A deal activity throughout, plenty of consequential Delaware rulings and FTC and DOJ actions, two seriously consequential U.S. presidential elections, and the seemingly never-ending spectacle that is Brexit in the UK. Our upcoming January 2020 "New Year" issue will take a look back at not only 2019 but also the entire turbulent and exciting ten-year period.

It feels a bit like we're in a cusp period at present—that in five to 10 more years, the M&A landscape may look quite different. There's the potential of a much more aggressive antitrust regime in Washington starting in 2021. Concerns about that scenario are likely causing some companies to push ahead with proposed mergers in the short- and medium-term, and thus keeping volume active. But a number of other things appear to be in an interim state at the moment.

Take corporate governance. Many company boards look different from how they did even 15 years ago. Once upon a time, it wasn't uncommon for a chairman to stock a board with personal friends or business allies. That's far from the case now for many companies. There's greater pressure on boards to increase diversity, to address concerns of activist shareholders, to have a broader perspective beyond the next quarter or fiscal year.

The Business Roundtable's announcement in August of its new Principles of Corporate Governance may be a watershed moment. For over 20 years, each version of the document the Roundtable issued had endorsed the principles of shareholder primacy—that corporations exist principally to serve shareholders. The 2019 Statement pushed that aside to outline instead "a modern standard for corporate responsibility," in response to, as Business Roundtable Chairman Jamie Dimon said, the growing belief that "the American dream is alive, but fraying."

A question is what this could mean when it comes to mergers. For example, can a selling company choose to go with a buyer has an attractive "corporate responsible" profile but that's offering a lower price than a company with a more controversial reputation? How will shareholders respond, if so? I wouldn't be surprised to find those issues being hashed out in court over the next few years.

There's also a generational shift getting underway—many lawyers who came of age during the "merger mania" of the 1980s will be heading off into retirement over the next decade. There will be new perspectives and greater diversity in law firms: it should be a fascinating period to watch unfold. As we have for nearly 25 years, *The M&A Lawyer* will be there to chronicle it. Thanks for your support, and I hope that all of our readers have a happy holiday season.

See you in the 2020s.

Chris O'Leary

Managing Editor

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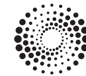

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