Freshfields

Horizon 2020

Critical intelligence for boards in a fast-changing world

January 2020

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Welcome to Freshfields' Horizon 2020

Introduction

The operating environment for multinational corporations in 2020 is set to be more volatile than ever. Economic conditions are uncertain, geopolitical instability casts a long shadow over global markets, regulatory regimes are evolving at speed and debate about the role of business in modern society continues to rage.

Against this backdrop, the boards of public companies face a host of challenges. How can a coherent, long-term strategy be constructed when the short-term outlook is so dynamic? What impact will climate change and other environmental and sustainability concerns have on businesses and markets? How can technology be harnessed for growth amid shifting regulatory regimes? And how should directors engage with investors whose objectives may not always match their own?

Delivering success requires a sophisticated understanding of this rapidly changing landscape. On the pages that follow we explore the key issues for boards and management in 2020, and offer practical guidance on how best to respond.

With clarity of thought and careful preparation, every challenge can be addressed — and every risk becomes an opportunity. Best wishes from us all at Freshfields for a prosperous 2020.

Executive summary

Governance, HCM, ESG and the purpose of a corporation

"Good" corporate governance continues to be a big focus for investors and other stakeholders. But one of the challenging issues for companies is the lack of agreement on what is relevant, with each stakeholder seemingly having a different focus. Against this backdrop, it is critical for boards and management to identify what is important to their company and be proactive about disclosure and engagement on terms that are meaningful to their various stakeholders. A company-led effort on this front will be more productive than reactively responding to an ever-increasing number of disparate requests.

In **Leveraging talent for growth**, we focus on the continually growing importance of human capital resources in a labor market characterized by skills shortages, uneven wage growth and rapidly changing technology, and the corresponding focus by investors and other stakeholders on these issues. Boards and management need to proactively identify their most significant HCM-related issues and craft meaningful disclosure and effective engagement strategies so that stakeholders are fully apprised of what companies are doing in this critical area. Similarly, in **What sustainability means for business**, we describe the need for a more rational approach to disclosure and communication on ESG issues, that shifts from passively responding to overlapping (and at times conflicting) requests for information to proactively communicating with a wide range of stakeholders about a company's risks and opportunities created by strategic ESG concerns. Shareholders, employees, consumers, supply chain participants and regulators all have a vested interest in focusing on the issues that matter. We also highlight some of the risks of getting it wrong, including the threat of litigation. While the trend is still relatively nascent, and early cases have not had a high degree of success, we expect plaintiffs will continue to bring claims on a variety of grounds.

All this focus on HCM, ESG and other governance issues can lead one to wonder about the true purpose of the corporation. In **Reforming the US corporation**, we address the question of whether boards can serve more than their shareholders. The answer is, and has always been, yes. But as the power of impact investing intensifies and the market's focus on the company's effect on other constituencies grows, boards and management are at risk of being driven to make decisions that benefit "other constituencies" to an untenable extent. This section highlights ways in which boards and management can protect themselves from unnecessary risks by, for example, carefully reviewing projections and forecasts the company disseminates to the market and considering the benefits of being a public benefit corporation.

These issues are at the center of the 2020 proxy season agenda. In **Shareholder proposals**, we describe how the shareholder proposal landscape continues to be robust with proposals submitted on a wide variety of E, S & G topics. In **Employee benefits: the forward view**, we note that transparency on compensation program design will keep Say on Pay in the spotlight throughout 2020. Similarly, compensation proposals continue to be routinely submitted by shareholders. Companies that receive less than 90 percent approval on their Say on Pay vote or that receive shareholder proposals relating to compensation practices should expect to engage in meaningful outreach to investors, generally together with a member of the compensation committee, and provide additional disclosure in their proxy statement. Directors should be prepared to articulate how the company's compensation structure is designed to support its long-term strategy and how the company plans to address any perceived shortcomings and inequality in the company's pay practices. In this section we also cover some recent proposed IRS regulations that may impact the deductibility of compensation paid under certain contractual arrangements.

The amount of time and resources companies devote to managing the shareholder proposal process also continues to increase, and we explore the potential impact of certain changes by the SEC (either adopted or proposed) to the regular cadence of shareholder proposals and proxy advisory firm recommendations. Again, in **Shareholder proposals**, we describe how the SEC has proposed changes to the shareholder proposal submission and resubmission process that may have a significant impact on the number of proposals that certain shareholders are eligible to bring. Conversely, some of the reforms related to proxy advisory firms are unlikely to have a meaningful impact on the 2020 proxy season, with proxy firms continuing to release their voting policy updates and to provide specific voting recommendations. For companies that submit requests for no-action relief to the SEC, we note that the SEC has recently issued guidance reiterating the importance of including the board's views on some key issues. Given that the shareholder proposal landscape is expected to continue to be frothy, in **Proxy advisers: the essentials**, we underscore the importance of effective engagement and disclosure strategies as a way of ensuring that shareholders and the proxy advisory firms understand a company's unique circumstances, thereby increasing the likelihood of having a successful voting outcome.

Significant trends in litigation and enforcement

While the pace of enforcement actions may have slowed over the last few years, the level of civil litigation has been consistently high. We are seeing higher levels of event-driven litigation, litigation grounded in insufficient board oversight, climate-related litigation and further use of Section 220 demands.

Trends in Delaware litigation highlights two significant developments in the Delaware courts with which boards should be familiar. First, we describe the import of the Marchand and Clovis cases, both of which were focused on whether the level of director oversight was sufficient. And while these cases relate to companies in heavily regulated sectors, they underscore the need to focus on board-level compliance programs and their oversight that can help directors avoid similar outcomes. Second, we describe the rise of Section 220 requests relating to stockholders' statutory right to inspect corporate books and records for a "proper purpose." There are several measures that boards and management can take to limit the amount and type of information that courts may allow shareholders to access, including to ensure that minutes and records are sufficiently detailed and complete to mitigate any demands for personal communications (such as personal text messages and emails). In **Key themes in litigation**, we note that several other trends will color the litigation landscape for companies in the US, including more event-driven litigation brought on the heels of the disclosure of bad news such as #metoo scandals, bribery and product claims, more third party-funded lawsuits as well as more climate change and sustainability-related cases. Interestingly, we are also seeing more globalized litigation, including class actions. The global nature of these trends emphasizes the importance for boards of not only understanding the risks of litigation, but also the risks of whether that litigation can be global and proactively implementing protective steps to ensure that the jurisdictional scope of any possible risk is appropriately cabined.

The globalization trend in litigation can be felt in the enforcement area as well. In **Priority areas for global enforcers**, we describe the increasing cooperation among global regulators and the continued focus on individual liability in the US and globally. Far from simplifying the process, the global nature of enforcement can also result in significant challenges, such as the different treatment of interview notes and privilege and the difficulty of navigating conflicting regulatory requirements. In no area is this more acutely felt these days than data privacy, where companies will need to continue to focus on how best to store, manage and protect their data. For these reasons and many others, board and management oversight, combined with robust risk management, should continue to serve as the first lines of defense in areas of enforcement.

Activism, M&A, antitrust and national security concerns

Stockholder activism remained a prominent tactic in 2019 and there is no reason to suspect a contraction in 2020. While each situation is different, **Trends in stockholder activism** highlights the key themes that emerged in 2019, including increasing activity at large caps where exits are logistically simpler given the greater liquidity opportunities. We also look at how M&A transactions continue to drive activism campaigns – underscoring the essential need for companies to sell the M&A deal to investors by demonstrating

why the acquisition fits their strategy and why the price is right – and the increasing interest in activism campaigns on the part of actively managed funds and first-time activists. Given this sustained activity, it is critical for boards and management to understand their standalone plan and effectively communicate it to investors, thereby dispelling any investor misunderstandings or skepticism.

As in years past, activism campaigns have also led to M&A activity. In **Deal-making 2020**, we describe the factors that will influence M&A in 2020 including continued macro uncertainty, the challenges of navigating complex antitrust and national security regimes, and the need to continually evolve to emerging opportunities such as ESG and digitalization. Amid these challenges, boards will need to be well prepared so that they can move quickly to spot and execute opportunities.

With corporate venture capital programs on the rise as companies continue to expand their investment portfolios in an effort to keep pace with technological change, another key trend that we expect to continue is described in **Corporate minority investments**. Founders are increasingly looking to join forces with strategic corporate investors willing to provide funding alongside a commercial partnership. And while boards generally need not micro-manage small minority stakes, it is important that they maintain oversight of the strategy and associated risks, since the potential reputational and operational consequences for a corporate strategic investor are higher than for a traditional financial sponsor. In particular, boards should understand the strategic objectives underlying their investment portfolio and how they fit with the company's overall strategy, the compliance and regulatory risks arising from the more limited diligence performed in connection with these investments as well as the possible conflicts arising from multiple board representations and co-investments from competitors.

Understanding the M&A landscape for 2020 also requires an in-depth focus on antitrust and a thorough understanding of CFIUS and other national security regimes. In **The shifting antitrust landscape**, we describe the potential impact on deal approval of several themes, including the intensifying focus from enforcement authorities on the tech sector, the increased length of review and rigor in complex merger cases (particularly at the DOJ), the rising number of investigations into innovative businesses and the likely impact of the presidential election on antitrust considerations. Many of the 2020 presidential candidates have raised concerns about the power of certain businesses and antitrust enforcement more generally, so boards need to keep developments in the political landscape in mind as the year progresses.

In **Navigating foreign investment rules**, we note that the regulations implementing the 2018 Foreign Investment Risk Review Modernization Act, the most sweeping reform of CFIUS in 30 years, will take effect in February. It will be imperative for boards to track these developments as they will have major consequences for how investments are made, cross-border collaboration and a host of other issues that may be important to the development of future technologies. Moreover, the continuing consensus that China poses a leading threat to US national security will continue to make deals with the PRC very challenging. Finally, here, too, the globalization trend has become evident. Today over 100 countries have laws that allow the review of foreign investment on security or public interest grounds, so boards and senior management will, more than ever, need to consider foreign investment issues early on in any cross-border deal to avoid any unwanted surprises.

Regulation of the business of technology

As virtually all companies can be characterized as technology businesses, regulators are increasingly focusing on the specific issues that are raised by this shift in business models.

For example, 2019 was characterized by major fines imposed by European regulators and the FTC relating to cybersecurity matters and violations of data protection regulations, and we expect these trends to continue in 2020 in Europe and the US. In addition, in **Technology and business**, we describe how antitrust agencies have begun, and are expected to continue, to regulate the collection and use of personal data. This is a potentially fundamental shift representing an effort to block certain data collection and uses in themselves, rather than merely regulate how data practices are disclosed. We also expect to see transfers of data between countries to be a continuing focus for regulators. With the California Consumer Privacy Act having come into force on January 1, will 2020 be the year that the US adopts a federal data privacy statute as many other countries now have? These data privacy statutes and regulations are presenting challenges for boards as they

continue to grapple with how best to discharge their fiduciary duties in an ever-evolving regulatory landscape. In recognition of the significance of these issues on a company's strategy, risks and reputation, the SEC has issued new guidance on the disclosure requirements for US reporting companies in relation to technology, intellectual property and cybersecurity risks. In **SEC disclosure obligations** we describe the importance for companies of getting this right, as it continues to be a top priority for the SEC.

In **Taxing the digital economy**, we note that this year there are likely to be important developments in the way many countries tax cross-border business. In particular, US corporations that provide goods and services to European consumers through the internet, rather than a local presence, are likely to face increased foreign taxes. In addition, the US Treasury has recently proposed new rules that, if adopted, would help protect US taxing jurisdiction over income from an increasingly important form of e-commerce: cloud computing. Together with management, boards will need to consider their global structures for marketing and distributing goods and services and determine whether any structural changes are necessary to deal with the increased tax burden.

Appropriate regulation of gig employees has been a hotly debated issue in recent years as the number of gig employees in the digital economy steadily increases. In **Employee benefits: the forward view**, we note that the EU Commission has better protection for gig workers high on its agenda. While it is not yet clear what this means in practice, one of the EU Commissioners has indicated that they intend to review carefully California's Assembly Bill no. 5, which limits the ability of companies in California to classify workers as independent contractors rather than employees. The EU is also considering whether gig employees should be allowed to collectively bargain for their rights, which would go against customary practice in the US. As the nature of the workforce undergoes dramatic changes, these issues present serious strategic questions for boards and management teams who will need to tread carefully about how they handle their most valuable assets, their employees.

Financing and refinancing updates

Finally, for companies wondering about the state of the credit markets amid all of these changes, in **Debt forecast**, we note that the sustainability trend continues to influence financing considerations, and that sustainability-linked instruments and loans offer issuers lower margins when they meet certain ESG criteria. We also highlight the rising risk of creditors who hold short positions in loans and bonds in the credit default swaps market pressuring borrowers to declare defaults. Boards can protect against this threat by ensuring that their company has negotiated robust contractual protections. In addition, companies should review any credit documentation based on forms that are more than a year or two old as borrowers have been able to agree ever-looser covenants and obtain additional flexibility from lenders in recent years. We also remind boards that with the fast-approaching end of LIBOR in 2021, companies should ensure that they have renegotiated or otherwise addressed any financing instrument with a floating rate interest tied to the benchmark rate.

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Leveraging talent for growth

Emphasizing the "human" in human capital management

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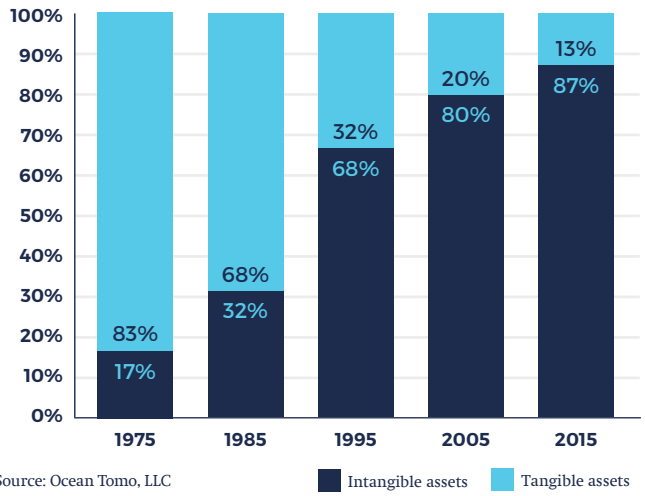
In recent decades the employees of a company have become, in many respects, one of its most significant assets. As a result, the ability to recruit, train and retain employees is becoming a measure of corporate success. Businesses with strong track records in this area are increasingly finding a competitive advantage in a labor market characterized by skills shortages, uneven wage growth and rapidly-changing technology.

It can be difficult to quantify the impact of an effective approach to human capital management (HCM), and companies have struggled with how to invest in and describe an area not directly reflected in their financial statements. However, investors recognize that part of a company's market value is driven by intangible factors such as these – poor HCM practices have been associated with higher employee attrition rates and reduced productivity and product quality.[1]

In response, companies and investors have focused on private ordering disclosure in the absence of mandated transparency, although these efforts have not yet coalesced around specific universal indicators or metrics. Having said this, in September 2019 the Sustainability Accounting Standards Board (SASB) announced its Human Capital Research Project, which will identify a framework of financially-material HCM issues.[2]

Institutional investors, including BlackRock since 2018 and State Street since 2019, have also indicated that discussions regarding HCM are an engagement priority, with BlackRock focusing its HCM engagement on issues such as policies, diversity initiatives and compensation linked to HCM performance, alongside employee programs, diversity pay gaps, organized labor engagement and supply chain (including contractors and contingent workers, among others).[3] State Street meanwhile is focusing on corporate culture "as one of the many, growing intangible value drivers that affect a company's ability to execute its long-term strategy".[4]

S&P 500 market-value contributors



Source: Ocean Tomo, LLC

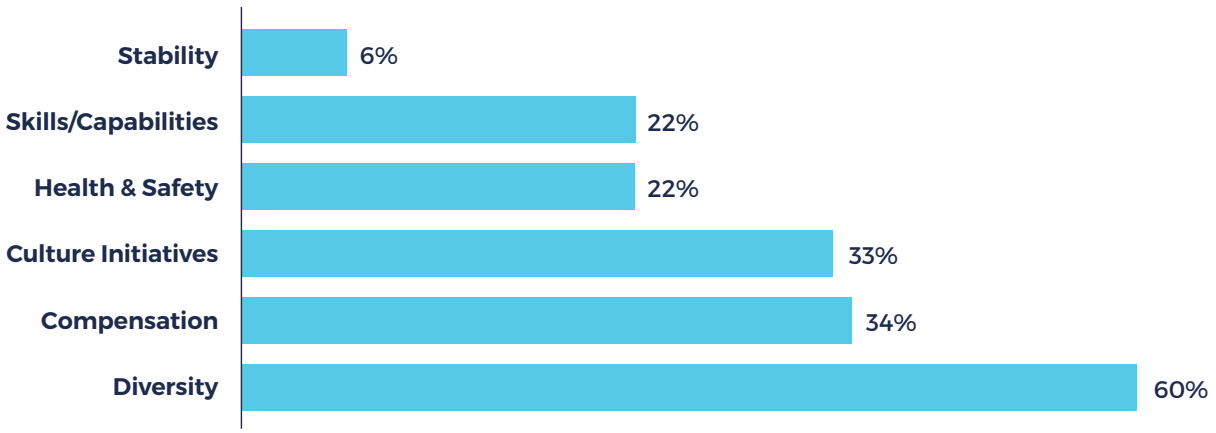
How are companies addressing HCM in their disclosure?

A 2019 analysis of Fortune 100 companies' proxy statements by EY revealed that HCM disclosure remains limited and is often noted only as part of the description of committee responsibilities. However, there are early indications at the start of the 2020 proxy season that companies are devoting more resources to this area.

For companies that are beginning to address HCM disclosure there are a variety of options, including:

- letters to shareholders from leadership;
- incorporating in risk oversight responsibility explanations;
- seeking directors with HCM skills/qualifications and including information in director biographies;
- including in shareholder engagement topics;
- factoring into growth strategy;
- adding as a performance factor in compensation/awards; and
- incorporating in diversity and inclusion metrics and goals.

Voluntarily-highlighted HCM workforce disclosure subjects in proxy statements[5]



Source: EY

The SEC steps in?

In 2017, a group of more than 25 institutional investors (representing more than $2.8 trillion in assets) sent a letter to the SEC requesting that it require registrants to disclose information about their HCM policies, practices and performance. In 2018, another group (representing more than $5 trillion in assets) sent a similar letter echoing the prior request.[6]

In March 2019, the SEC Investor Advisory Committee (IAC) issued a recommendation to the SEC supporting expanded HCM disclosure to include:

- employee classification;
- KPIs on diversity, hiring and promotion, safety, training, and employee satisfaction; and
- a statement on competitive conditions.

In August 2019, the SEC released a proposal for rule amendments to modernize and simplify the description of business under Regulation S-K, which (in part) included human capital resources (e.g. recruitment, development, and retention) as a separate required disclosure topic if material to understanding the company's business.[7] The proposal has proved controversial; some issuers responded that the disclosure would be burdensome and without sufficient benefit, while some investors and others urged the SEC to expand the information requirements. This will be an area to watch in 2020 as companies begin to think about how they will modify their disclosure if the proposed rules are finalized.

In 2020 we expect HCM issues to be of growing importance to investors, employees, regulators and other stakeholders alike. As the number of constituencies focused on these issues increases, so does the diversity of the types of information that may be relevant to each. In addition, this challenge can have significant reputational consequences and an adverse impact on employee morale if mismanaged. For these reasons we believe it is critical for companies to ensure that they are disclosing their HCM efforts and initiatives so that stakeholders are fully apprised of what they are doing. They should proactively identify their most significant HCM-related issues and craft meaningful disclosure. It is also vital that they develop an engagement strategy that offers compelling information to stakeholders, rather than being reactive to requests for information that is not relevant to the company. Doing so can be an effective way to manage the multiplying requests for disparate information that companies receive in this area.

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What sustainability means for business

ESG, climate change and litigation risk

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The legal risks associated with climate change and other environmental, social and governance (ESG) factors will continue to feature prominently in 2020 for three primary reasons.

1. Investors continue to request increasing amounts of information on ESG issues;
2. National and regional regulators are beginning to expand their ESG purview; and
3. Climate-related litigation is evolving beyond claims for historical emissions to failures relating to disclosures and permitting requirements.

Pressure from investors and other stakeholders grows

One of the greatest challenges that companies face regarding disclosure of environmental and sustainability issues is the lack of uniformity in what stakeholders are seeking. Sustainability is not a consistently defined term, with each stakeholder ascribing to it a different meaning and, therefore, a different set of expectations.

In recent years we have seen increasing interest among investors in these issues, yet each has a particular view of what information they would find useful and what topics they would like to discuss during their engagements. At the same time the number of stakeholders focused on ESG matters has spiked. For example, consumers and other customers have become very focused on sustainability, particularly in relation to packaging, water usage and energy. Employees, long focused on the mission of their companies, are becoming more vocal about ESG matters. Supply chain issues have been catapulted to the forefront of public consciousness following high-profile scandals. And regulators often find themselves squarely in the middle of the debate.

Against this backdrop, the disclosure agenda is currently more stakeholder- than regulation-led; various constituencies are seeking more clarity on material ESG risks while the regulatory environment is still developing. In the US, there are no line-item disclosure requirements

when it comes to sustainability. Back in 2010, the SEC published Commission Guidance Regarding Disclosure Related to Climate Change,[8] which underscores that existing disclosure requirements already cover environmental and sustainability issues and that the threshold for disclosure is materiality. At the same time, several organizations, including the Sustainability Accounting Standards Board (SASB), have attempted to devise frameworks that could assist companies in determining and disclosing material sustainability risks in a way that enables investors to compare them across companies and industry sectors.

The focus on material disclosures is also reflected in the work of the Task Force on Climate-related Financial Disclosures (TCFD) which seeks to develop voluntary, consistent climate-related financial risk disclosures by which companies can provide information to investors, lenders, insurers and other stakeholders. TCFD members – which include leading corporates and financial institutions – are seeking to both show leadership in disclosure and influence regulators for pending disclosure regimes.

In some jurisdictions, stock exchanges are also steering disclosure, either by making ESG transparency a listing requirement (e.g. Euronext France) or by proposing a set of guidelines for voluntary disclosure (such as on the London Stock Exchange and NASDAQ).

So, what should companies do? In a world of overlapping (and sometimes competing) expectations, both boards and management need to determine for themselves what issues are material to their company and ensure that they satisfy their disclosure obligations and risk oversight duties. But they cannot stop there – in this ever-evolving landscape, they should also acknowledge that there are many other issues that, while not material, may nevertheless be important to investors and other stakeholders. (Click here to read our report on how institutional investors currently treat the flood of ESG quantitative data). For these issues, rather than responding to the constant requests for disparate information, companies should develop their own disclosure and define their own engagement strategies to provide stakeholders with the information they seek. Being proactive in this way gives boards and management the opportunity to have a meaningful dialogue with their stakeholders about the issues that are important to them and to the company, without diluting the message with less useful information.

Regulators are catching up

National and regional regulators are looking to meet the obligations of the Paris Climate Agreement, and, to a lesser extent, the UN Sustainable Development Goals.

In some jurisdictions, especially in Europe, lawmakers are seeking to expand disclosure requirements to include ESG considerations. The EU's Sustainable Finance Action Plan, for example, provides recommendations to companies on reporting how their activities impact climate change and the effect climate change is having on their business through a classification system (or taxonomy) of what constitutes sustainable business activity. Critics of the EU plan however question whether the detailed classification system is sufficiently clear or meaningful to guide companies or investors.

Central banks are also weighing in, driven by concerns about physical risks to assets and supply chains caused by extreme weather events and transition risks that will arise as regulators', investors' and consumers' demands shift to address the threat of climate change. To date, 46 central banks and regulators have joined the Network for Greening the Financial System, launched by Mark Carney, governor of the Bank of England (until March), and his counterparts in France and China, among others.

Hong Kong regulator requires mandatory ESG reporting

In December 2019, Hong Kong's front-line regulator, the Hong Kong Stock Exchange (HKEX), announced that boards of listed companies will now be required to issue statements setting out their consideration of ESG issues.

ESG reporting started as a voluntary exercise in Hong Kong in 2012, evolving into a "comply or explain" regime with recommended disclosures in 2016. However, a periodic review of ESG reporting by 400 public companies during the 2017/18 financial year revealed a "mechanical, box-ticking" approach that lacked "a desirable level of quality and depth of detail". In response the HKEX imposed its mandatory reporting obligation, which establishes ESG disclosure and risk management as an issue on which boards must take the lead.

HKEX's plea for boards to disclose what is material (or in its own words, "truly material") is helpful, as is the regulator's position that comply or explain are both "acceptable options". Boards and management now need to take a thoughtful approach to reviewing all the subject areas, aspects, general disclosures and KPIs in the HKEX's ESG reporting guide, so that the assessment, consideration, determination, and follow-through expected by the regulator can be achieved.

There is a fairly long transition period as it is acknowledged that issuers will need to put internal infrastructure in place to capture the data required. The first enhanced ESG reports will have to be published by issuers for any financial year starting after July 1, 2020 (i.e. the first reports will cover the period from January 1, 2021 to December 31, 2021 for issuers that have a December 31 year-end), although the HKEX is encouraging issuers to start the process as early as possible.

Legal risk and climate change

According to data from Columbia University and the London School of Economics, there have been almost 1,400 climate-related lawsuits launched around the world, with more than 130 aimed at companies by the start of December 2019.

> **We expect more "behavior-moderating" cases in 2020 in which litigants expand the focus of their claims from past emissions to current and future corporate revenue-generating activities.**

Broadly speaking, climate-related cases can be split into three groups.

1. **Common law tort and public nuisance cases** of the type that emerged in the US around 20 years ago and have since begun to spread in Europe. These claims are primarily designed to hold companies to account for allegations related to their past environmental conduct, and have often failed to get past initial hearings.
   In the US, this is primarily because federal law and regulators like the Environmental Protection Agency take precedence over state legislation – and because US courts view responding to climate change as a matter for government policy. In other countries, litigants have generally been unable to satisfy the causation and other legal tests required to bring their claims.

2. **Cases that take aim at future corporate conduct**, for example by demanding improved disclosures around climate-related risk and/or changes in strategic direction in relation to carbon emissions. These claims may be more attractive to plaintiffs where issues of material non-disclosure are present, but are still challenged by the struggle to meet strict causation tests.
3. **Cases that involve challenges to the granting of industrial permits** on the grounds that climate change impacts have not been properly considered. Although not as high profile, suits that target the "licence to operate" are potentially more significant for businesses.

There are likely to be more "behavior-moderating" cases in 2020, in which litigants expand the focus of their claims from past emissions to current corporate revenue-generating activities. Furthermore, claims will no longer be brought just by governments and NGOs; we expect a growing number of individuals to launch shareholder suits, and institutional investors to add their voices to calls for greater transparency.

For more information on legal risk and climate change take a look at our research report on the climate risk landscape, which examines the emerging threat of litigation against multinational corporations.

In some jurisdictions, lawmakers are expanding disclosure requirements to include ESG considerations. Central banks are joining in, driven by concerns about physical and transition risks.

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Reforming the US corporation

Can boards serve more than their shareholders?

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In 2019, we witnessed, in a year of rocky IPOs, the success beyond all expectations of the Beyond Meat listing. The differentiator: socially conscious investors (focused, in this instance, on the environmental benefits of a shift to plant-based food) comprised the critical component of the underwriters' IPO order book that was missing from other, less successful, flotations. Estimates put the assets under management of impact investing at more than $500 billion, dwarfing the $143 billion dedicated to activist equity strategies.

As the magnitude of funds aimed at socially beneficial businesses has grown, investors and their intermediaries (such as proxy advisory firms like ISS and Glass Lewis, independent designers of best practices for disclosure like the Sustainability Accounting Standards Board, and watchdog and rating organizations like Sustainalytics) have contributed to the proliferation of ways to measure and evaluate each corporation's impacts on the environment, customers, workers and local communities.

Countering the focus on short-term growth

The companies in the IPO pipeline for 2020 – and indeed lots of existing publicly-traded corporations – are now considering how to harness this development to improve relations with their spectrum of stakeholders. But to achieve this objective, they will need to take innovative steps to manage two countervailing forces.

First, a slice of the market remains focused on metrics that indicate rapid, short-term growth to the exclusion of all other objectives. Up until now, companies have failed to counter this dynamic. Yes, fluffy statements by founders and CEOs about long-termism and values regularly take up space in IPO prospectuses and follow-up communications. But these well-intentioned sentiments are at risk of being overwhelmed by management's widespread distribution of powerful data that is often incompatible with these sentiments and ironically does not even make it into the IPO prospectus: internal financial projections.

All the founders' letters and statements of corporate values in the world are not going to alter the commitment to near-term growth at all costs that is necessary if management hands analysts and investors sets of aggressively optimistic management projections. This syndrome is especially problematic in connection with IPOs, where there is pressure to provide the best possible financial forecasts during roadshows.

> **"All the statements of corporate values in the world are not going to alter the commitment to near-term growth at all costs that is necessary if management hands the market aggressively optimistic projections.**

Are directors who think beyond shareholders in breach of their fiduciary duties?

Second, corporate law in most states provides that directors and officers must act in the best interests of the corporation and its shareholders, not other constituencies. There is a limit to how much a director can squeeze the square peg of benefiting "other constituencies" into the round hole of a duty to maximize shareholder value at every turn.

Interestingly, in advance of the Business Roundtable's recent pronouncement that looking out for stakeholders other than shareholders is part of the corporate mission, a number of clients called to ask whether their companies' support of the Roundtable's position would put their directors and officers in conflict with their fiduciary duties.

The answer was an easy, "No problem."

Because most states' corporate law provides that directors and officers must act in the best interests of the corporation and its shareholders, the Roundtable's statement relies on a realization that has been around for over a century: a company's actions that benefit non-shareholder constituencies may simultaneously be in the best interests of the corporation and its stockholders. Absent this realization, all acts of corporate charity and responsibility would constitute corporate waste.

> **"The Roundtable's statement relies on a realization that has been around for over a century – that a company's actions that benefit non-shareholder constituencies may simultaneously be in the best interests of the corporation and its stockholders.**

But as the power of impact investing grows and the market's measurement of corporations' impact on "other constituencies" becomes more precise (but also more disparate), fiduciaries of corporations are at risk of being driven to make decisions that benefit "other constituencies" to an untenable extent. The answer to clients' questions may start to become, "Actually, you may *not* be complying with your fiduciary duties if you take *that* step."

How boards can flip the narrative

In 2020, successful IPO issuers, and even some courageous companies that are already publicly traded, will have the opportunity to take strong steps to counter these two forces. First, management can moderate the growth projections they provide to the market, especially during IPO roadshows, and be comfortable that the cost of this decision will be offset by compelling, substantive disclosure that both details the company's public benefit and sustainability mission and is sufficient to attract a healthy layer of impact investors into the IPO order book and long-term shareholder profile.

Second, the limits of corporate law can be overcome by taking advantage of a Delaware statute that has until now been virtually ignored by publicly traded companies. It provides that a corporation may amend its charter to become a public benefit corporation (or PBC) and redefine fiduciary duties to focus on not only the interests of shareholders but also the interests of other constituencies (and, even better, of whatever public benefits the charter specifies). Moreover, this statute generously insulates directors and officers from claims for breach of duty so long as no self-dealing is involved.

Delaware legislature needs to help corporations make the shift

That said, there are a few fixes that the Delaware legislature needs to adopt urgently to permit corporations to move in this direction. For one, modifications should be made that harmonize the process of conversion to a PBC with the provisions applicable to other charter amendments – the requisite shareholder approval should be reduced from 66⅔ percent to a simple majority of the outstanding shares, and the conversion to a PBC should not trigger appraisal rights. In addition, the statutory protection of fiduciaries against liability should make clear that the holding of shares by a director or officer would not, by itself, result in her being deemed to be engaged in self-dealing that negates her insulation from liability if her balancing of shareholder value, other constituencies, and the designated public benefit ends up favoring shareholder value.

Finally, when a corporation's narrative is framed by detailed environmental and social impact disclosure and the adoption of an alternative fiduciary duty paradigm, the insulation of this narrative through structural features (such as high-vote shares for the pre-IPO stockholders and a classified board arrangement whereby only a third of the directors are up for re-election each year) becomes justifiable rather than a source of controversy. It is no longer the ability of self-centered founders to do whatever they want that is being insulated – rather it is a well-articulated and designed mission to serve a broader purpose than short-term growth.

The limits of corporate law can be overcome by taking advantage of a Delaware statute that has until now been virtually ignored by public companies.

Freshfields

Employee benefits: the forward view

Say on Pay, activism and compensation deductibility

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Say on Pay remains on investors' agenda

High investor demand for transparency on compensation program design will keep Say on Pay in the spotlight throughout 2020. The proxy advisory firms continue to enhance their voting guidelines with a clear focus on ensuring a strong orientation towards "pay for performance", with ISS introducing an "economic value added" metric in its quantitative pay-for-performance analysis. Companies should be aiming for a Say on Pay vote that is supported by at least 90 percent of shareholders, and should expect to engage in meaningful outreach and provide robust proxy disclosure of the process. This should include the lessons learned from shareholder concerns and any compensation changes made in response, particularly where Say on Pay support falls below the 90 percent threshold.

In 2019, some of the primary reasons for poor shareholder support included lack of performance-based long-term incentives, short performance periods for long-term awards, discretionary short-term incentive plans, improper peer group composition for compensation benchmarking and vague or incomplete disclosure. Through 2020 we expect shareholders to continue to seek common compensation program features including a pay mix heavily weighted toward performance-based rewards, comprehensive claw-back mechanisms, meaningful stock ownership policies and the elimination of tax gross-ups.

Compensation-related proposals continue to drive shareholder activism

Shareholder activism has been on the rise in recent years, with compensation-related proposals at the center of this movement. There is also a developing trend of proposals derived from employee shareholders, with new generations of workers more aggressive in challenging their employers in relation to social goals.

These shareholder proposals have attempted to address various topics, including inequitable employment practices, sexual harassment risk management, gender pay equity, gender diversity on boards, employee representative directors and other environmental, social and governance (ESG) factors. We expect boards and compensation committees to give increasing consideration to such factors when making compensation decisions as they become more important to stakeholders. This will require a careful balance with the more traditional financial and operational performance goals that are fundamental to the growth and success of any for-profit business.

> **"Companies should aim for 90 percent support for any Say on Pay vote, and should expect to engage in meaningful outreach and provide robust proxy disclosure of the process.**

IRS guidance on executive pay deductibility

Section 162(m) of the Internal Revenue Code imposes a $1 million cap on the deductibility of compensation paid to certain executives by public companies. Prior to the passage of the Tax Cuts and Jobs Act of 2017, Section 162(m) included an exclusion from the cap for commission-based and qualified performance-based compensation. For tax years beginning after December 31, 2017, the Tax Cuts and Jobs Act amended Section 162(m) so that, among other things, it will cover more executive officers and will no longer include these exceptions.

> **The IRS's August notice left many questions unanswered and there remains a fair amount of uncertainty as to the proper application of the rule.**

The Tax Cuts and Jobs Act provides an important transition rule (commonly referred to as the "grandfather rule") for compensation offered under a "written binding contract" in effect on, and not "materially modified" after, November 2, 2017. Compensation covered by this rule is subject to the more favorable Section 162(m) rules that were in force prior to the enactment of the Tax Cuts and Jobs Act. On August 21, 2018, the Internal Revenue Service (IRS) issued Notice 2018-68 to address key questions regarding the scope of the grandfather rule. However, this notice left many questions unanswered and there remains a fair amount of uncertainty among practitioners as to the proper application of the rule.

In late December 2019, the IRS issued proposed regulations expanding on the guidance released in August 2018 to provide more clarifications on the grandfather rule and to further limit some aggressive positions previously being taken by taxpayers. Public companies should consult legal counsel regarding the impact that this new guidance may have on the deductibility of compensation paid under pre-existing contractual arrangements.

New international standard for whistleblower protection

Outside the US, a new EU directive on whistleblower protection entered in force in December 2019, setting out a European framework that has far-reaching implications for global businesses.

The directive introduces "common minimum standards" to protect workers from retaliation if they report breaches of laws in specific EU policy areas. As a result, it comes with a limited material scope yet it establishes for the first time an international standard in the absence of any other law at EU or international level governing whistleblowing procedures.

The EU Commission made clear in its communication that it would like member states to implement the directive in the broadest way possible. Implementation must happen by December 2021, after which businesses will have to establish channels for internal reporting and member states will have to designate a national authority for external reporting.

> **The EU directive requires companies to protect whistleblowers' identities and to respect data protection rights.**

It is similar in some ways to the US system, which has a well-established methodology for reporting misconduct that is reflected in industry practice and in the DOJ's guidance from 2019. The DOJ guidance allows allegations to be reported either confidentially or anonymously, while the EU directive requires companies to protect whistleblowers' identities and to respect data protection rights (in particular the right of individuals to access their personal data under the EU General Data Protection Regulation). The issue of whether anonymous reporting is permitted is left to the discretion of EU member states. In response to this shifting landscape, global employers should encourage internal whistleblowing and establish a single whistleblowing system across their operations.

EU Commission considers protections for gig workers

The new EU Commission, which took office on December 1, 2019, has put better protection for gig workers high on its agenda. What this means in practice remains to be seen, but the Commission could go as far as to grant self-employed workers the same rights as full-time employees, including allowing them to enter into collective bargaining. Nicholas Schmit, the EU Commissioner for Jobs and Social Rights, has said he believes it is important to address new forms of precariousness in the labor market in preparation for future downturns in the digital economy, and has expressly referenced California's Assembly Bill no. 5 – which was enacted in September 2019 – as an initiative he admires. The bill limits the ability of companies in the state to classify workers as independent contractors rather than employees.

Margrethe Vestager, the former EU Competition Commissioner who has been reappointed to an expanded brief as Executive Vice President for a Europe Fit for the Digital Age, has previously declared that gig economy workers are falsely labeled as self-employed. In her view they should be allowed to collectively bargain for their rights, and that if they did it would not constitute unlawful cartel behavior.

> **The EU Executive Vice President for a Europe Fit for the Digital Age, Margrethe Vestager, believes gig economy workers should be allowed to collectively bargain for their rights, and that if they did it would not constitute unlawful cartel behavior.**

If this approach is implemented in the EU it would go against customary practice in the US, where collective bargaining for non-employees generally does not exist.

The new EU whistleblower directive comes with a limited material scope yet establishes for the first time an international standard in the absence of any other law.

Freshfields

Shareholder proposals

A renewed focus on process

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While early indications from the 2020 proxy season are that existing substantive trends in shareholder proposals are likely to continue, there have been some significant changes to the SEC's process for reviewing and responding to no-action letter requests, as well as proposed new rules relating to the submission and resubmission of shareholder proposals. If passed, these measures are likely to have a major impact on how the landscape evolves.

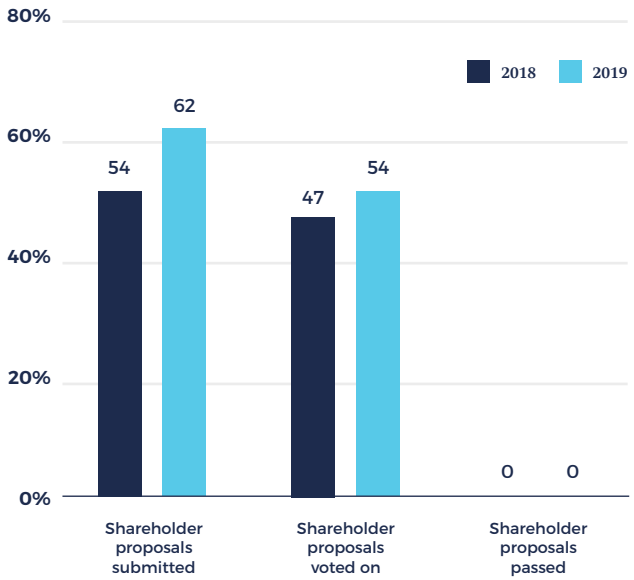
Early indicators: trends in shareholder proposals

Initial trends in shareholder proposals seem consistent with those of the last few years. However some notable developments for this proxy season include the following.

Governance – separation of chair and CEO. Investors and shareholder proponents continue to focus on independent leadership. Since 2015, shareholder proposals relating to this issue have been unsuccessful, but there remains a steady submission of proposals for independent board chairs, evidenced by the incoming requests for no-action relief through mid-December 2019.

Interestingly, for the 2020 proxy season, Legal & General Investment Management, a large asset manager based in the UK, announced that it will vote against or withhold in connection with all combined chair/CEOs.

Shareholder proposals for independent chairs



Governance – shareholder ability to effect governance changes. For the 2020 proxy season, proponents continue to submit proposals requesting changes that provide shareholders with greater power to enact governance changes, including the ability to act by written consent and via lowering the threshold by which special meetings can

be called by shareholders. While such proposals generally have not succeeded (only 10 of the 64 combined proposals passed in 2019), they continue to generate significant support from shareholders. Companies that have received these proposals (or are at risk of doing so) should engage with their shareholders to determine the best course of action. Because support can be high – and companies often face repeat proposals – companies should also engage with their shareholders after the vote and ensure that disclosure about any next steps and rationale is included in their following year's proxy statement.

E&S – environmental. Environmental shareholder proposals are not going away, and it can be difficult in many cases to exclude proposals under Rule 14a-8, in part because repeat proponents have become skilled at developing submissions for which there is little basis to request no-action relief. The good news for companies is that in the 2019 season, environmental proposals were withdrawn at the highest rates after engagement, and those that went to a vote received majority support relatively rarely. As companies have increased their efforts and related disclosure in these areas, investors have shown slightly less appetite for such shareholder moves.

E&S – diversity. In 2019 the New York City Comptroller launched Boardroom Accountability 3.0, which requested the adoption of the Rooney Rule for board candidates and CEOs at 56 companies. In this context, the Rooney Rule would require companies to adopt a policy requiring the consideration of women and diverse candidates for every director and CEO search. Combined with related shareholder proposals and increasing focus among investors on diversity at board, committee, leadership and executive management levels, we expect this topic to remain top of mind in 2020. Companies should continue to review and revise board policies and nominating and governance committee charters, as well as proxy disclosure on these issues.

E&S – lobbying. In a significant election year, scrutiny of political lobbying disclosure is likely to increase (as it tends to whenever voters go to the polls). In 2020, this builds on momentum from an already robust 2019 proxy season on this issue.

The SEC's procedural changes for responding to no-action requests in the 2020 proxy season

In 2019, the SEC released additional guidance as it relates to shareholder proposals and related requests for no-action relief.

- The SEC Division of Corporation Finance released informal guidance that its Staff may decide not to respond by letter to all requests for no-action relief. In some cases the Staff will email the company and proponent that its response will be posted to an online chart. The Staff also noted that it may decline to take a view on a request, but that companies should not interpret the declination as a requirement to include the proposal in the company's proxy materials.[9]

What the SEC's proposed changes to shareholder proposals rules mean in practice

In November 2019 the SEC released proposed rules on, among other things, procedural requirements for submission of shareholder proposals and resubmission thresholds. They reflect the SEC's focus over the last few years on modernizing the shareholder proposal process.

Potential changes to shareholder proposal procedural requirements.

- Ownership requirements would be a multi-tiered system that would depend on the dollar amount held as a factor of time, reflecting a connection between economic commitment and investment horizon rather than the current $2,000-held-for-one-year rule. Unlike the now ubiquitous proxy access construct, shareholders would not be permitted to aggregate ownership to meet any of the thresholds.

Value of stock	No. of years continuously held
$2k	3 years
$15k	2 years
$25k	1 year

- Proponents would be required to provide information regarding their availability to engage with the issuer within 10 to 30 calendar days after submitting the proposal.
- Each person would be limited to one proposal per company per year, whether as a proponent or representative. Currently, proponents may also serve as representatives for other shareholders.
- Representatives and the proponent would be required to provide additional information about themselves and their proposal.

If adopted as proposed, we expect that the revised requirements will impact the number of shareholder proposals that are submitted annually by serial proponents. The decrease is likely to be most acute for governance-related proposals, which have long been a particular focus for gadfly shareholders.

Shareholder proposal resubmission thresholds.

- The SEC also proposed changes to increase the minimum level of support for a proposal that has been put to a vote when a proponent wishes to resubmit it.

Submission	Current resubmission threshold	Proposed resubmission threshold
1st	3%	5%
2nd	6%	15%
3rd	10%	25%

- The proposed rules would also allow registrants to exclude proposals that have been voted on more than three times and have received between 25 and 50 percent shareholder support, but whose backing has declined by more than 10 percent between the last two votes.[10]

Unlike the previous change, these reforms are not expected to impact the number of proposals that are resubmitted and eventually receive majority support, which was a key factor in the SEC's choice of revised thresholds.

The SEC's focus on board analysis in no-action letter requests

For the third year in a row, the Staff released a Staff Legal Bulletin discussing the provision of board analysis in company no-action letter requests, particularly those that argue for exclusion under the ordinary business exception. Many companies found the focus on board analysis challenging; the timing of the receipt of shareholder proposals and the typical board calendar do not align particularly well, and many boards would not ordinarily dedicate significant meeting time to individual proposals. As a result, in the first year that the Staff mentioned board analysis, many companies that put in the work to provide the information on short notice were disappointed with the Staff's response. The most recent Staff Legal Bulletin provided clarity on the factors the Staff would find helpful in such analysis, which include the possibility that management provide information about the board's prior analysis or actions taken. This would alleviate some of the timing issues, and although the Staff admits that the inclusion of board analysis does not guarantee concurrence with a company's argument, as it continues to focus on and refine what it is seeking in requests for no-action relief, a company that is considering submitting a request under the ordinary business exception should think about whether it can make a cogent argument that includes considerations that relate to the board.

Freshfields

Proxy advisers: the essentials

Dealing with the proxy advisory firms

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According to empirical estimates, proxy advisory firms can swing a vote by 30 percent or more at a public company. Given the influence of ISS, Glass Lewis and the like – who have no share ownership themselves – it is unsurprising that the focus on them has been intense.

The SEC has taken an especially close interest in their practices in recent years. In particular, in August 2019 it released informal guidance regarding the applicability of federal proxy rules to proxy voting advice, including that of proxy advisory firms. In November 2019, the SEC proposed new rules that would codify its informal guidance that proxy voting advice is a solicitation subject to Section 14(a) of the Exchange Act. In order to continue to rely on an exemption from compliance with the filing requirements for solicitations under the Act, the proxy advisory firms would need to satisfy certain disclosure and procedural requirements.

Amid claims that the August guidance threatened the proxy advisory business model, ISS filed a suit shortly before the rule proposal was released, arguing that the guidance:

- exceeds the SEC's statutory authority under the Exchange Act;
- is procedurally improper under the Administrative Procedure Act; and
- is "arbitrary and capricious".

SEC skirmish continues, but for companies it is business as usual

While the proxy advisory firms and the SEC continue to have a public skirmish over regulation, it has become clear that the SEC's intention is not to regulate proxy advisory firms out of business. Therefore, for companies entering the 2020 proxy season, it is, in almost all respects, business as usual, with the proxy firms continuing to release their voting policy updates and providing specific voting recommendations on management and shareholder proposals.

Part of the drive behind the SEC's focus on regulation is the increasing frustration that many feel with the way the firms operate. Companies recognize the proxy firms' power, but some find it difficult to engage with them and drive change, or feel unable to have their individual circumstances appreciated. It can be hard for companies to take measured and considered action (especially if done in consultation with their shareholders) only to be told that their policies and practices do not fit in the "check-the-box" mold of the voting policies and scorecards and as a result are generating "against" votes.

> **"It can be hard for companies to take measured action only to be told that their policies and practices do not fit in the "check-the-box" mold and as a result are generating "against" votes.**

For companies considering how to manage votes and their relationships, engagement and disclosure remain the best strategy to counteract the pressures they face. As shareholder bases continue to be dominated by large institutional investors that maintain their own voting policies and practices, proactive engagement permits companies to drive their own narrative and explain potential differences with the proxy advisory firms' approaches. Further, disclosure of significant engagement efforts and results of those shareholder interactions can be useful in getting proxy firms – which are also ultimately accountable to their customers – to consider a company's particular circumstances.

Engagement will not be feasible for every company, nor will every investor be available for in-depth discussions. This underscores the importance of sufficient specific and expository disclosure that can drive a narrative even when facetime is not possible. While this creates more work for management, and often the board, companies that engage in these exercises well are increasingly finding that the investment is worth the cost.

Engagement will not be feasible for every company, nor will every investor be available for in-depth discussions. This underscores the importance of sufficient and expository disclosure that can drive a narrative even when facetime is not possible.

Freshfields

Trends in Delaware litigation

Managing the threat of stockholder action

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Several decisions from the Delaware courts in 2019 are relevant to boards as we head into 2020. Chief among them are a number of *Caremark*-related rulings that highlight the importance of active, engaged board oversight of "mission critical" risk and compliance issues, and the continued use of (and litigation surrounding) Section 220 requests for books and records.

What *Marchand* and *Clovis* mean for boards

Delaware courts have long acknowledged that *Caremark* claims[12] – which allege failure of board oversight – are among the "toughest" for plaintiffs to plead and prove. More than a decade ago, the Delaware Supreme Court held that to survive the pleading stage and ultimately succeed, stockholders must show that boards either 1. "utterly failed to implement any reporting information restrictions or controls"; or 2. having implemented them, "consciously failed to monitor or oversee their operations, thus disabling themselves from being informed of risks or problems requiring their attention."[13] Since then, virtually no cases alleging *Caremark* claims have survived the pleading stage.

However in 2019, in *Marchand v. Barnhill*,[14] the Delaware Supreme Court ruled that claims under the first prong of *Caremark* against the directors of an ice cream manufacturer, Blue Bell Creameries, could go forward past the pleading stage, following a 2015 listeria outbreak in which three people died. The court ruled that the complaint had alleged facts from which it could be inferred that Blue Bell's directors had failed to put in place a board-level oversight system for food safety – which was "mission critical" for the monoline company – and as a result had not received official notices of deficiencies for several years.

Among other things, the Supreme Court noted that the complaint alleged that there was no board committee that addressed food safety; no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks or reports; and no schedule for the board to consider on a regular basis any key food safety risks that existed. The Supreme Court explained that "… as with any other disinterested business judgment, directors have great discretion to design context- and industry-specific approaches" to compliance oversight, but "*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort – i.e. try – to put in place a reasonable board-level system of monitoring and reporting."

> **"As explained in *Marchand*, to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it. This is especially so when a monoline company operates in a highly regulated industry.**

The *Clovis* case[15] involved the second *Caremark* prong, and revolved around a monoline company's flagship lung cancer drug, Rociletinib ("Roci"). The complaint alleged that Clovis's management overstated Roci's efficacy in clinical trials, using unconfirmed data on tumor shrinkage (a violation of both accepted trial protocols and Federal Drug Administration standards). Clovis eventually came clean, with the subsequent $1bn drop in its market value sparking a securities class action, an SEC complaint and the derivative claim. In the latter, the Delaware Court of Chancery denied a motion to dismiss, ruling that the complaint alleged facts from which it could be inferred that while the company had compliance systems in place, directors "ignored multiple warning signs" that management was inaccurately reporting Roci's efficacy based on certain presentations that had been made to the board. As was the case in *Marchand*, it remains to be seen whether the allegations in both cases will be proven in later phases of the litigation.[16]

So, what are the lessons from *Marchand* and *Clovis*? While neither signals any change in Delaware law, they are good reminders of the need for boards to implement and monitor a risk oversight system for material risks that a company faces. This is particularly true for boards of monoline companies, and boards of businesses in regulated sectors, who should pay close attention to any core risks and compliance requirements. In *Clovis*, the Court noted that where "externally imposed regulations govern a company's 'mission-critical' operations, the board's oversight function must be more rigorously exercised." As always, boards should map these critical risks and ensure that they have the right monitoring and reporting structures, and board expertise, in place.

Practical guidance for boards

1. Directors should identify any key or material risks to their business, set up board-level compliance and monitoring systems (including appointing directors with the knowledge to understand technical issues), and make good faith efforts to ensure that these mechanisms are working as they should.
2. Boards should also review the efficacy of their compliance and monitoring on a regular basis, whether biannually or even quarterly.
3. It is important to pay close attention to the documentation of board oversight and monitoring. Have the reporting and monitoring mechanisms been appropriately documented? Have all reported issues been noted, as well as any actions taken by the board to address known risks and deficiencies? Does the documentation show what directors are doing to stress-test their compliance systems?

Section 220 litigation

Section 220 demands relate to stockholders' statutory right to inspect certain corporate books and records for a "proper purpose". They are a tool for plaintiffs to obtain discovery ahead of litigation against directors, and are also utilized by activist investors.

2019 saw a further rise in Section 220 demands, as well as a continued increase in related litigation. While limits have been set around their use in recent years, the cases outlined below show that the Chancery Court will enforce Section 220 demands where it believes investors have met the statutory requirements.

1. *Inter-Local Pension Fund GCC/IBT v. Calgon Carbon Corp.*[17] was filed after Calgon's board refused to produce information in connection with the company's sale to Kuraray. The Section 220 demand related to the board's process and knowledge before the deal was signed, and allegations of wrongdoing in connection with compensation and benefits paid to Calgon's senior officers. The Court held that the plaintiff's purported purposes to inspect were genuine and that they had established a credible basis to suspect mismanagement. Despite this, the Court ruled that the plaintiff was only entitled to limited production – and did not have the right to see emails between Calgon's management and Kuraray.
2. In *Kozinski v GGP Inc.*[18] – which related to the merger between GGP and Brookfield – the defendant argued that the Section 220 demand and subsequent litigation were lawyer-driven, and that there was no credible basis to infer misconduct. Again, the Court permitted inspection, although this time the scope was left to be negotiated in the first instance between the parties.
3. Similarly, in *Donnelly v. Keryx Biopharmaceuticals Inc.*,[19] the stockholder sought books and records regarding suspected breaches of loyalty and improper disclosure by the board following Keryx's 2018 merger with Akebia. Once more the Court found a proper purpose for inspection and credible basis to suspect mismanagement or wrongdoing, rejecting the assertion that the demand was counsel-driven and pretextual. However, the Court declined to shift attorneys' fees, finding that the company had raised a good-faith dispute over the purpose and scope of the demand. The Court again left it to the parties to negotiate the proper scope of documents to be produced.
4. Finally, *Bucks County Employees Retirement Fund v. CBS Corp.*[20] was filed after CBS's board refused to produce certain documents requested in connection with allegations surrounding the company's merger with Viacom. As with *Calgon*, the Court held that a proper purpose for inspection had been stated, but also ruled that a "narrow" set of certain emails linked to a specific meeting did have to be produced. The Court emphasized that it "[did] not mean to endorse the plaintiff's approach here as a 'playbook' that should be followed by other stockholders who may seek to challenge transactions preclosing."

Practical guidance for boards

1. The Delaware courts continue to enforce the use of Section 220 demands where the statutory requirements are met.
2. They have allowed shareholders access to board documents, and in limited circumstances to certain emails, including where there are gaps in official board documentation.
3. Directors should ensure that their minutes and corporate records are sufficiently detailed and complete to mitigate demands for email communications.

Freshfields

Key themes in litigation

From "event-driven" claims to the rise of third-party funding

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We expect several trends to color the litigation landscape for public companies based – and doing business – in the US in 2020.

More "event-driven" litigation

In recent years we have seen a rise in the volume and seriousness of litigation driven by bad news. Cyber attacks, "#metoo" scandals, bribery, product claims – all are on the radar screens of companies. Now, PR problems more frequently generate litigation risk for both businesses and their directors. In response, boards are becoming more focused on their preparation for event-driven crises. We have long seen directors insist on incident response plans, and some have done "table-top" exercises to practice how they would work with management in the wake of a serious problem. Now, some are even conducting unannounced drills to see just how robust their planning has been.

> **Cyber attacks, "#metoo" scandals, bribery, product claims… PR problems are more frequently generating litigation risks for both businesses and their directors.**

The globalization of litigation

With the US plaintiffs' firms expanding into Europe and Asia, we are increasingly seeing plaintiffs' counsel engaging in litigation arbitrage – that is, bringing global cases in the jurisdiction that offers the most procedural and substantive advantages (often the United Kingdom). For example, Hausfeld, a US-based plaintiffs' firm with several European offices, brought class actions in both the US and the UK alleging that certain financial institutions rigged foreign exchange benchmarks. Notwithstanding that some defendants settled the US claims, they are now faced with litigating substantively similar claims in Europe. And where foreign plaintiffs bring a claim outside the United States against a US defendant (or an affiliate), they can further enhance their position by seeking discovery from the US entity under Section 1782 of the US Code. At the same time, the ever-evolving jurisprudence concerning the extraterritorial reach of US law has resulted in certain US courts entertaining claims arising out of non-US conduct.

More class action risk globally

Over the past decade, more and more countries have begun to implement class and mass claim mechanisms that borrow in varying degrees from the US class action system. In the coming year we expect countries, particularly in Europe, to use these new rules more aggressively.

More third party-funded cases

Third-party funding has been on the rise for some time and continues to proliferate. With increasingly sophisticated investors working as (and with) third-party funders, the landscape of commercial disputes is changing around the world. Under-capitalized and sometimes unsophisticated parties – both individuals and companies alike – are now being assisted by funders who provide much more than capital. They are becoming more heavily involved in strategy and the resolution of disputes, making commercial disagreements more threatening and increasing the care with which companies must handle previously straightforward challenges. At the same time, third-party funding may provide a corporation (including significant global businesses) with a new source of (relatively) cheap financing or a way to reduce its legal spend.

More climate change and sustainability-related litigation

As explained in our section on ESG there have been close to 1,400 climate-related lawsuits launched around the world. More than 130 of these involve companies as defendants, and it should come as little surprise that we expect this number to increase in 2020.

Thus far, companies facing claims for purportedly contributing to global warming have been successful in court. However, this does not mean there is no litigation risk. In the short term, the biggest challenge to companies relates to disclosure; are they doing what they say they are doing? Consumers, activists, investors, regulators and attorneys general all will be keeping a close eye on this area, and in the longer term companies should expect plaintiffs to pursue a variety of avenues to try to hold them liable for contributing to climate change.

Practical guidance for boards

Directors of corporations with global operations need to recognize the global risk of litigation to which their companies may be exposed and actively take steps to manage it.

They would be well-served to:

1. analyze their global litigation risk and consider whether their corporate structures and data handling policies protect them from litigation in key global jurisdictions in which they operate;
2. ensure that the board is educated on key cross-border litigation risk issues, so that it is in position to appropriately evaluate and direct litigation strategy when confronted with global litigation; and
3. when confronted with litigation in one jurisdiction arising out of multijurisdictional conduct, consider whether a global resolution is possible in one jurisdiction, and if not, take steps to appropriately cabin the scope of the proceedings in that jurisdiction.

> **Increasingly sophisticated investors are becoming more heavily involved in strategy and the resolution of disputes, making commercial disagreements more threatening.**

Freshfields

Priority areas for global enforcers

What's on the agenda for regulators and prosecutors?

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Ongoing cooperation among global regulators

US regulators and enforcement authorities continue to cooperate and coordinate both with each other and with their counterparts abroad in investigating potential misconduct. Companies involved in multijurisdictional investigations should be aware that US regulators may be able to access information and data from overseas, and should also be sensitive to the challenges and potential pitfalls that may arise when responding to regulators in multiple jurisdictions. These challenges may arise, for example, with respect to differing treatment of interview notes and privilege, the degree of coordination that regulators may expect and approaches to data protection and production. They may also be exacerbated by the trend towards increased corporate enforcement activity across the globe.

> **The common challenges for boards when responding to regulators in multiple jurisdictions include the differing treatment of interview notes and privilege.**

Continued focus on individual liability

US and global regulators remain focused on pursuing the individuals responsible for corporate misconduct. Recent trials against individuals have, however, exposed the government's liability theories to heightened scrutiny and, sometimes, rejection. As an example, the DOJ lost one of its first two spoofing prosecutions, and has faced mixed results in recent bribery-related trials. In the UK, the courts this past year rejected prosecutors' attempts to hold the leaders of UK financial institutions criminally liable for alleged mismanagement during the financial crisis. Such outcomes have been less common with corporate defendants, which tend to settle enforcement actions well before trial.

> **Prosecutors have begun to explore novel legal avenues by which to pursue individuals, charging them under laws that, for example, toll the statute of limitations.**

With the DOJ's charging theories increasingly tested, companies and their management teams should be aware that prosecutors have begun to explore novel legal avenues by which to pursue individuals – charging them under different, more accommodating laws that, for example, toll the statute of limitations or lack a complicated history of judicial interpretation.

Expansion of, and more experience with, the FCPA Corporate Enforcement Policy

The DOJ continues to revise and expand its 2017 Corporate Enforcement Policy (CEP), extending its principles to successor companies and beyond the Foreign Corrupt Practices Act (FCPA) context. In addition, in late 2019 the DOJ published revisions to the CEP, clarifying that companies should self-disclose potential violations as early as possible as opposed to waiting until after an investigation has been substantially completed. Put differently, the CEP continues to demonstrate how focused the DOJ is on getting companies in the door.

> **The possibility of a reduced penalty or declination from the DOJ may be less appealing if it brings sanctions in other jurisdictions – and civil litigation exposure.**

Companies eager to reap the CEP's potential benefits should still, however, be mindful that authorities in different jurisdictions have divergent expectations with respect to corporate cooperation. The potential for a penalty reduction or declination from the DOJ may become less attractive if achieving it would result in hefty consequences in other jurisdictions (along with potential civil litigation exposure).

Discovery and privacy challenges: navigating conflicting regulatory requirements

Multinational companies have long faced challenges handling and producing data across borders. The 2018 implementation of 1. the EU General Data Protection Regulation (GDPR), and 2. the US Clarifying Lawful Overseas Use of Data Act (CLOUD Act) have done little, in practice, to simplify the data protection landscape, especially for companies caught at their intersection. Indeed, such businesses (particularly internet service providers) are subject to potential conflicts between US authorities and non-US privacy regulators, where the former might seek evidence stored abroad, the disclosure of which may run afoul of the GDPR (or of any of the myriad other data protection regimes, blocking statutes, and other data-related restrictions around the world).

Companies caught in the middle should:

1. be thoughtful about where and how they store their data across business units and corporate entities;
2. document efforts to comply with the GDPR, the CLOUD Act and other data-related regimes to defend against claims of breach; and
3. be aware that, in the wake of the first UK-US Bilateral Data Access Agreement, it has become easier for authorities in each country to obtain data directly from firms in the other by removing conflicting privacy restrictions facing these businesses.

Cyber enforcement focuses on disclosure and unfair trade practices

The US lacks an all-purpose, comprehensive data protection regime like the EU's GDPR or those found in other jurisdictions. Nevertheless, US federal and state regulators have used a patchwork of special-purpose regimes – derived from statutory, regulatory and common law sources at both the federal and state levels – to bring enforcement actions, including in particular in relation to cyber incidents. Here, recent high-profile cases have stemmed from allegations of unfair/deceptive trade practices. For further information, please see our section on technology and business.

US federal and state regulators have used a patchwork of special-purpose regimes to bring enforcement actions, including in the cyber arena.

Practical guidance for boards

1. Investigations into disparate industries (from antitrust regulators scrutinizing big tech companies to the criminal probe of drug companies in the wake of the opioid crisis) highlight a common lesson: while it is important to remain mindful of "traditional" threats like corruption, cartels and accounting fraud, companies should increasingly stay vigilant and try to anticipate potential risks that may be lurking around the corner, including from less familiar sources.
2. Board and senior management oversight, combined with robust risk-mapping and versatile risk-management plans, should continue to serve as the first lines of defense in quickly evolving areas of enforcement. In addition, companies should be aware that their governance and management of risk are often the critical first points of regulatory scrutiny, particularly outside of the US.
3. Companies should also take stock of their compliance programs and ensure that they are nimble enough to cover emerging challenges, including ones related to data, the environment and human rights.

Freshfields

Trends in stockholder activism

Where will campaigns focus next?

Paul Tiger
Partner, New York

While activist campaigns were down slightly year-on-year in 2019, stockholder activism remained a prominent tactic. Looking ahead to 2020, there is no reason to suspect a further decline. Activists notched some big wins over the year, notably Elliott in its campaign at AT&T, which saw the telecoms conglomerate announce it would conduct a full review of its portfolio, not make any further major acquisitions, add two new directors and separate the CEO/chair roles after the current CEO retires.

While each situation is different, several themes emerged during the year.

Increasing activity at large-caps

Elliott was able to effect change at AT&T with a $3.2 billion stake that only slightly exceeded 1 percent of the company's market cap, while eBay and Cerner were also targeted in 2019. One significant advantage for the activists in hunting "big game" is that the market cap of these companies – as well as the depth of the liquidity in the public markets – permits relatively quick exits once they have achieved victory. Some activists have struggled to unload investments in mid-cap companies over a number of years, suggesting large-caps will continue to be targeted thanks to their strong exit potential.

Deals continue to drive campaigns

Several companies had to contend with activists last year after they announced a large acquisition. Carl Icahn is seeking to elect four directors to the board of Occidental Petroleum and make sweeping governance reforms following the company's announcement of its $38 billion deal to acquire Anadarko without stockholder approval (topping Chevron's $33 billion bid to buy the shale oil company). Likewise, Paulson & Co announced it would vote against Callon's acquisition of Carrizo Oil & Gas, and United Technologies was criticized by Third Point for its merger with Raytheon. For public company buyers, selling the deal to the Street – demonstrating how the acquisition fits with the company's strategy and why the price is right – has long been an important element of the buy-side M&A process and is now even more essential. It also potentially presents heightened risk for targets, particularly if the buyer needs a stockholder vote to complete the deal.

> **"We are increasingly seeing activists advocating, straight out of the box, for the sale of entire companies. The pretense that the activist brings operational brilliance is disappearing rapidly.**

Going straight for the M&A endgame

A regularly used playbook by activists had been to advocate for operational and capital allocation reforms and then, when these brilliant ideas from the Park Avenue offices of hedge funds failed to spark a turnaround, push for a sale of the company. Since the unexpected success JANA achieved with the quick sale of Whole Foods, we are increasingly seeing activists advocating, straight out of the box, for the sale of entire companies. Break-ups, divestitures, and accretive combinations are also on the agenda, but the pretense that the activist brings operational brilliance to the boardroom – as opposed to just a voice pushing for a quick all-cash sale – is disappearing rapidly.

Actively managed funds are increasingly playing the activist

As money continues to move into passively managed index funds and ETFs, actively managed funds are feeling the heat to distinguish themselves. Increasingly they are turning to activism to do so; in 2019 we saw campaigns by Wellington (which was given standalone voting authority from Vanguard in 2019), T. Rowe Price and Neuberger Berman, among others.

First-time activists are getting in on the hunt

While the headline-grabbing stories tend to be those involving the brand-name funds, first-time activists are emerging at a steady pace. They often have similar objectives (and pursue similar tactics) as more established activists, and are often even founded by departed executives from older funds. However, these newer activists are eager to make a name for themselves and see their first engagement as a route to build their reputation and credibility. The rate at which they are appearing suggests an active, enduring market with sufficient capital to sustain new entrants.

Flexible strategies endure

Activists continue to flex their operational strategies in ways that make them more nimble and agile. Several funds (Trian, Mantle Ridge, Third Point) are in the practice of establishing “single name” funds or special purpose vehicles (often called sidecars) to raise money for a particular investment. These sidecars can give activists access to more cash than they would normally want to be responsible for deploying, allowing them to pick their spots when going after bigger companies from time to time. Activists have also continued to use derivatives to secretly build their positions, notably in Mantle Ridge’s campaign at Aramark.

Europe becomes a focus

Q3 2019 saw the greatest number of campaigns on record in Europe, with activity shifting away from the UK towards Germany, Switzerland, France and, to a lesser extent, the Benelux countries. Several of those involved are familiar faces (including Elliott, Trian and Third Point) and they often employ the same strategies they use in the US. We expect this dynamic to continue in 2020 – especially if there is dispersion among European companies in terms of how they are affected by Brexit and other headwinds.

First-time activists are emerging at a steady pace. They often have similar objectives as more established funds – but are eager to make a name for themselves.

Practical guidance for boards

Given this sustained activity, boards and management need to:

1. have confidence in, and understand, their standalone strategic plan;
2. effectively communicate to investors the superiority of this plan relative to alternatives;
3. consider whether and how to address investor misunderstandings and concerns about the strategic plan, either through better disclosure or reforms;
4. strike the right balance between the company's "good governance", and defense and preparedness, profiles – taking into account that this balance will be determined by each company's specific circumstances; and
5. engage with shareholders to explain the fact-specific justifications for what they may perceive to be "good governance" shortfalls and any plans for addressing them.

Freshfields

Deal-making in 2020

M&A drivers for the year ahead

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Looking ahead to what we might expect in M&A through 2020 and beyond, it is important to consider how we got here. Activity was robust in 2019 (though "down" from a superlative 2018 in both value and volume terms), and revealed to the careful eye several themes that both inform our view of last year and help put 2020 into proper focus.

There were 48,847 deals valued at $3.67 trillion in 2019, down from 51,473/$4.04 trillion in 2018. Activity was highest in the technology, media and telecoms sector (including Worldpay/Fidelity National Information Services and First Data/Fiserv) and as discussed below it is no surprise that the two largest tech deals of the year were cross-sector. Following tech, the other leading sectors for deals were energy (including Anadarko Petroleum/Occidental Petroleum and Saudi Basic Industries/Saudi Arabian Oil), healthcare (Celgene/Bristol-Myers Squibb and Allergan/AbbVie) and industrials (Raytheon/United Technologies and Fiat Chrysler/Peugeot). 2019 was also notable for its relative dearth of cross-border deals, with only two of the top 20 acquisitions by value (Fiat Chrysler/Peugeot and LVMH/Tiffany) involving buyers and sellers from different countries.

While lower overall, 2019's M&A figures are strong in a historical context and reflect a number of underlying drivers. Corporates had significant cash on their balance sheets, private equity sponsors had records amount of "dry powder", debt continued to be relatively inexpensive and equity markets remained elevated, making shares an attractive acquisition currency. The mood in the boardroom, too, remained cautiously robust, with well-placed organizations able to move quickly to spot and execute opportunities.

The mood in the boardroom, too, remained cautiously robust, with well-placed organizations able to move quickly to spot and execute transactions.

The continued certainty of uncertainty

Meta-level political destabilization events, enhanced regulatory approaches, potential and actual economic headwinds (including the inversion of the yield curve in 2018) and the sheer length of the M&A bull market that has run for most of the past decade, have left market participants feeling – much as they have for some time – that a dislocation of some type is around the corner. Nevertheless, deal-making (in reality portfolio optimization) has persisted, largely because the low-hanging fruit of tax reform earlier in the decade and achieving – or being pushed to achieve (see "ownerism" below) – operational improvements have been realized.

More specifically, we expect tougher foreign investment and antitrust enforcement regimes to continue to provide obstacles to deal-makers, although they will also create opportunity. CFIUS recently issued final regulations fully implementing the 2018 reform legislation which expanded CFIUS's jurisdiction, and, in March, the European Council adopted regulations to harmonize national security investment regimes across the EU. Against this backdrop it is little surprise that cross-border activity fell in 2019; indeed, China outbound M&A into the US and Western Europe reached a relative nadir, and, with ongoing uncertainty around trade disputes and fears regarding Chinese companies' relationship with the Chinese state (e.g. the US military's ban of TikTok), there is no indication it will increase any time soon.

With respect to antitrust, early in 2019 the Federal Trade Commission (FTC) announced that it would create a taskforce dedicated to monitoring competition in US technology markets (see our section on antitrust for further analysis). Deals, too, continued to be blocked around the world, such as the slated combination between Republic National Distribution Company and Breakthru Beverage Group in the US, and the proposed joint venture between ThyssenKrupp and Tata Steel by the European Commission. While the DOJ cleared the merger of Sprint into T-Mobile, several state attorneys general sued to block the transaction, another potential trend to watch out for. In addition, as one of the repercussions of Brexit, the UK's Competition and Markets Authority (CMA) will no longer be subordinate to the EU, subjecting many international transactions to another regulator that will continue to assert its power and assume a very active role in merger control.

> **"While regulatory intervention will continue to add uncertainty to the transaction landscape, these pressures may also lead to opportunities as deals are unwound and acquirors from less-scrutinized jurisdictions take advantage of reduced competition.**

While regulatory intervention—as well as political and trade dynamics playing out through existing and new regulations—will continue to add uncertainty to the transaction landscape, these pressures may also lead to opportunities, as deals are unwound and acquirors from less-scrutinized jurisdictions take advantage of reduced competition. For example, CFIUS ruled in 2019 that both PatientsLikeMe and Grindr needed to be divested from Chinese investors. And it is perhaps no coincidence that, when combined with strong and supported balance sheets, Japan outbound M&A continued at a vigorous pace in 2019.

Ownerism – it's not just for activists any more

The activist toolkit – and the way corporates respond – has been well-developed over the past 30 years (see our section on trends in shareholder activism for more analysis). Reflecting on the past decade and looking ahead, we are struck by the commonality across asset classes and the renewed vigor with which all owners (such as activists and long funds in public companies, VC investors and private equity sponsors) are adopting the active owner mentality, which in turn drives transactional activity. From activist white papers and wolf-packs to sponsor dry powder, it all comes down to a strong bias against status-quo – a rebuke to laissez-faire governance that M&A participants are well advised to note.

In 2019, traditional activist investors both fomented deals by pushing companies to sell or spin-off non-complementary businesses (or to use the cash on their balance sheets) and prevented them by challenging transactions that had been announced. As an example, Carl Icahn pushed for the Eldorado Resorts deal for Caesars Entertainment but tried to stop Occidental's acquisition of Anadarko. In addition, traditional private equity sponsors such as KKR, Sycamore Partners and Golden Gate Capital have acquired small stakes in public companies in order to leverage their position into buyouts. And, of course, there is the continuing trend of historic long-only funds (including large institutional money managers) becoming much more active in the governance space. While this all may appear haphazard, moving across asset classes as if by contagion, it is really just ownerism manifesting itself across the deal landscape.

Divestitures and the breakup of large conglomerates will also continue as a result of ownerism pressure or due to corporates turning that mentality on themselves. Among other examples, in 2019 DowDuPont completed its spin-offs of Dow Inc. and Corteva respectively as promised when Dow and DuPont merged in 2017.

In 2020, we expect to see a further corporate portfolio optimization, including due to ownerism pressure.

Review of the vision – the changing business landscape informing M&A

It is the ultimate platitude from the last decade to reflect on the rapidly-changing nature of our economy. One need look no further than all things related to mobile devices to see a massive vertical created around a product that only launched in the late '00s. But just because it is a platitude does not mean it is not real. Corporates and sponsors that ignored the development of green initiatives have been left playing catch up; likewise, industrials that have failed to embrace digitalization could find themselves quickly going the way of the buggy-whip industry. And businesses of all shapes and sizes that ignore the consequences of the #MeToo movement will be unable to attract and retain high performing people in a tight labor market that McKinsey could not have imagined when it produced the first version of its "War For Talent" paper in 1997.

Looking forward, 2020 may be the year that "green deals" come to the fore. With environmental, social and governance (ESG) and sustainability becoming investor watchwords, these issues are likely to impact deal activity in the year ahead. In a 2019 survey by IHS Markit, 53 percent of the senior executives questioned believed that ESG considerations would become significantly more important in M&A over the next 12 to 24 months. One example last year of an ESG-driven transaction was private equity giant KKR investing $900 million into NextEra Partners' renewable energy ventures.

Companies will likely be unable to ignore the continued influence of technology on their operations, and the economy more broadly, in the future. It is no surprise that last year's biggest tech deals also involved the financial services sector (including the Worldpay and First Data

acquisitions mentioned above, as well as London Stock Exchange Group/Refinitiv), while the digitalization dynamic was also evident in the acquisitions of AI start-ups Dynamic Yield and Apprente by McDonald's in 2019. We expect this trend to continue, with companies in cutting-edge areas such as AI and blockchain being bought by historically non-tech players trying to capitalize on the changing landscape.

Finally, the importance of, and focus on, diversity in organizations cannot be understated – while it has been known for some time that diverse groups make better decisions than homogeneous ones, the increasing focus in organizations (including with respect to M&A) from the board down will make the need for well-constituted, diverse boards a continued priority.

2020 may be the year that "green deals" come to the fore. With ESG and sustainability becoming investor watchwords, these issues are likely to impact M&A activity in the year ahead.

Freshfields

Corporate minority investments

Managing the risks of non-controlling stakes

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Corporate venture capital programs are on the rise, and founders are increasingly looking to join forces with strategic corporate investors willing to provide funding alongside a commercial partnership. These relationships give corporates the ability to hedge – in part by outsourcing risks and costs – against potentially disruptive technologies and provide access to research and development, intellectual property and innovation strategies. Minority investments also are increasingly the first step on a path to a full acquisition, giving a potential acquiror the chance to look under the hood or perhaps even providing a formal option to purchase 100 percent down the road.

These types of investments – individually and in the aggregate – are not often the subject of board-level discussion or review. And while a board generally need not micro-manage small minority stakes, it is important that it maintains oversight of the strategy and associated risks. The reputational and operational risks for a corporate strategic investor are higher than for a traditional financial sponsor, but there are efficient and effective ways boards and management can mitigate them.

Strategy and allocation of resources

Although investments may span multiple technologies and geographies, they should align with a company's goals and objectives and should not detract from day-to-day operations. For a corporate investor, achieving strategic objectives is often more important than economic return. Managing an effective investment portfolio frequently requires allocation of significant resources to each portfolio company, particularly where the investment is coupled with a commercial or IP arrangement. Boards should ensure that management maintains articulated strategic objectives for each investment that align with the board's own strategic vision, and has a plan to avoid overcommitting resources to investments with limited upside at the expense of primary corporate goals.

> **While a board generally need not micro-manage small minority stakes, it is important that it maintains oversight of the strategy and associated risks. The reputational and operational risks for a corporate strategic investor are higher than for a traditional financial sponsor.**

Compliance and regulatory risk

While an investor may not always be exposed to direct liability risk for the acts of a non-controlled subsidiary (aside from directly authorizing or aiding and abetting illegal activity), the reputational risk from regulatory or compliance breaches by a portfolio company is not insignificant. These investments are usually paired with co-marketing, co-branding and similar arrangements, often with the portfolio company touting the corporate's investment on its website or through other public means, exposing the corporate's brand to leakage. And in some cases regulatory requirements directly apply; the Foreign Corrupt Practices Act (FCPA), for example, imposes on a non-controlling shareholder a duty to use its influence in good faith to cause an investee to maintain a system of FCPA-consistent controls. Despite this, investors are frequently inclined to conduct limited diligence in connection with investments that are immaterial in dollar terms, when they should be focused on identifying specific risks and conducting thorough but targeted diligence. Boards need to ensure that management has processes in place to do so; several well-known corporates have recently been the subject of corruption investigations associated with investments and joint ventures outside the US.

Corporate investors must ensure their directors are aware of the inherent conflicts associated with sitting on multiple portfolio company boards.

Accounting for minority investments

Accounting for a corporate minority investment will differ depending on the investment vehicle, percentage ownership and non-economic indicia of control, among other factors. Boards should ensure management has procedures in place to monitor these accounting issues, and management should be aware of the differing accounting that results from, for example:

1. qualitative indicia of control that would require a company to account for a minority investment on the equity method or by consolidation notwithstanding economic ownership below 20 percent; and
2. accounting reforms that became effective in 2018 requiring companies to run certain measurable changes in the value of an investment, even when below 20 percent and accounted for on a cost basis, through net income – meaning that each subsequent investment round in a portfolio company could trigger the requirement to record a loss in the investor's P&L.

Portfolio company boards

Companies seeking investments from, and partnerships with, strategic investors will often request that the investor take a board seat – recognizing that the representation of a well-established strategic investor can provide significant credibility and experience to an early-stage company. However, corporate investors must be careful to avoid overboarding their employees. They should also ensure their directors are aware of the inherent conflicts associated with sitting on multiple portfolio company boards; the risks (including in relation to personal litigation) an employee assumes in becoming a director of another company; and the time required to be an effective board member.

To manage the tension between an employee director's duties to the company versus the investee, corporate investors should at a minimum have policies in place to ensure corporate opportunity waivers are obtained for director appointees, and that those appointees can share information with their broader corporate team (in each case where appropriate). Companies should also ensure there is sufficient indemnification provided to directors to limit personal liability. With respect to overboarding across portfolio companies, a board should ensure management has policies in place to manage risks including:

1. board appointments detracting from the ability of an employee to focus on the core enterprise;
2. the tensions that may arise if a director appointee's duty of candor to the portfolio company conflicts with his or her duty of disclosure to the corporation (or vice versa); and
3. the risk of an overlap between competitor boards being deemed an illegal interlocking directorate under the Clayton Act.

Companies can generally avoid the issues above by taking an observer seat instead of appointing a director, and should consider making an observer (with robust information rights) the preferred approach except where otherwise necessary or appropriate.

Competitor investors

Corporate investors may not want to risk being a co-investor in a target alongside a competitor. A portfolio company may be willing to give a strategic corporate investor a contractual right to veto an investment from a competitor or accept an investor blacklist. This is particularly the case if limited to a certain period or only for as long as the strategic investor keeps investing in subsequent rounds, but generally only if negotiated concurrently with the initial investment. If a contractual veto or blacklist is not an option, a corporate investor should consider up front the risks of competitor co-investments and whether the (often limited) ability to exit via a transfer is sufficient.

A well-counseled board of a company with significant minority investments should keep itself informed and ensure these risks are appropriately addressed by requiring periodic updates from management covering, at a minimum:

- investment strategy;
- size of the portfolio;
- criteria used by management to determine performance;
- potential reputational risk;
- an overview of board and other fiduciary roles across the portfolio;
- a summary of any past failures and related remedial actions taken; and
- management's approach to exits.

The importance of this kind of oversight is likely to increase in 2020 as companies continue to expand their investment portfolios in an effort to keep pace with technological change.

The shifting antitrust landscape

Themes in tech, merger control, consortium bids and innovation

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The digitalized economy

Last year saw broad debate in the US and worldwide as to whether there should be greater antitrust enforcement targeting the business models of digital platforms, and especially their use of data and algorithms – practices that have made many tech companies so successful. There has also been an increasingly active discussion around whether existing antitrust laws need reform to give the Department of Justice (DOJ) and Federal Trade Commission (FTC) the requisite tools to deal with issues raised by digital innovation.

In 2019 the FTC created a permanent Technology Enforcement Division, and is currently preparing digital guidelines relating to platforms in conjunction with the DOJ. Separately, state attorneys general have individually and collectively launched investigations into digital platforms.

In 2020, companies should expect heightened antitrust scrutiny of mergers where one or more parties has access to potentially valuable data, as well as those involving acquisitions of start-ups (sometimes called killer acquisitions). Likewise the business practices of digital platforms will be in the spotlight, including how they gather data or whether the data they hold could confer a competitive advantage or be considered an essential facility.

> The DOJ and FTC are closely scrutinizing the digital economy, and the FTC has created a special technology unit to investigate and assess competition in digital markets. Companies should expect a closer examination of transactions conducted in the digital space.

New vertical merger guidelines on the horizon

In early 2020 the DOJ and FTC issued draft vertical merger guidelines for public comment. In the related press release, they noted that vertical merger enforcement has evolved dramatically since the current non-horizontal merger guidelines were issued in 1984. The new guidance is intended to reflect the agencies' experience over the past 35 years, and more accurately outline their current enforcement approach.

The vertical merger guidelines will set out the DOJ and FTC's approach to assessing transactions between companies that occupy different levels in a supply chain, such as a manufacturer and a distributor, or a distributor and a customer. Historically, the agencies have taken the view that such combinations are less likely to harm competition than horizontal mergers, consistent with the view of academics and economists that vertical mergers raise few competition risks and often have greater potential for efficiencies than those involving direct rivals. The agencies typically have required remedies only in cases where a monopolist or near-monopolist at one level of the supply chain would have the ability and incentive to foreclose downstream rivals' access to a critical input, or where a firm acquires the only (or a key) upstream supplier for a critical input. Moreover, the FTC and DOJ have also been more willing in vertical cases to accept behavioral remedies, such as non-discrimination commitments or information firewalls. By contrast, in horizontal mergers the agencies have a strong preference for structural divestitures.

Under the Trump administration, the DOJ and FTC have shown heightened interest in vertical merger enforcement, best exemplified by the DOJ's effort in 2017-18 to block AT&T's merger with Time Warner. The case was the first effort by either agency to litigate a vertical merger challenge since 1977, when the DOJ sought to force Hammerhill, a paper manufacturer, to sell two paper distributors it had acquired in the 1960s. The DOJ lost that case, and suffered a similar fate in AT&T/Time Warner when the DC District Court rejected its claims and allowed the merger to proceed. The district court's decision was affirmed following the DOJ's unusual decision to appeal.

> **Following the DOJ's defeat in AT&T/Time Warner, some commentators declared the case to be an outlier. However commentary from the DOJ and FTC since the decision suggests vertical mergers will continue to be an enforcement priority.**

Following the DOJ's defeat, some commentators declared AT&T/Time Warner to be an outlier, inconsistent with historic US enforcement priorities and antitrust scholarship. However, commentary from the DOJ and FTC since the decision, culminating with the draft vertical merger guidelines, suggests that vertical mergers will continue to be an enforcement priority in the future.

Working with financial investors: consortium bidding and interlocking directorates

We have seen a sharp uptick in the volume of consortia deals in the past 10 years. Such transactions can be a means to pool resources to go after an asset that is otherwise too big to acquire alone. They can also involve financial investors engaging strategic partners with a view to combining assets to realize synergies, bring different expertise to the group or address capability requirements in remedies processes. Private equity investors are increasingly employing buy-and-build strategies or doing bolt-on acquisitions, both via joint investments and sequential deals.

Pooling resources can have material benefits but can also create risk. Acquiring targets as part of a consortium increases the likelihood of substantive competitive overlaps between the target and other portfolio company interests held by the investors. This is especially the case if the consortium includes strategic players and/or financial investors that have existing portfolio companies that are active in the same sector, even if they only hold minority stakes. It is crucial to identify potential competitive overlaps early in any deal process to be able to properly assess the level of antitrust risk and an appropriate strategic response, as well as allocating it among the parties.

More consortium members generally leads to a greater number of merger control and/or foreign investment control filings, with many jurisdictions triggering based on the turnover and/or assets of acquiring entities who will exercise control, even if the target has no turnover. Even minority stakes not amounting to control (with shareholdings as low as 10 percent) can give rise to filing requirements in some jurisdictions.

Companies should also expect enforcement to address any potential lessening of competition arising from so-called "common shareholdings" across the same industry. US agencies are this year expected to focus on cross-directorships, bringing enforcement actions where representatives of the same private equity firm sit on the boards of competing companies. Investors should ensure that where they have investments across an industry, they have appropriate confidentiality procedures in place.

> **This year, US agencies are expected to focus on situations where representatives of the same private equity firm sit on the boards of competing companies. Investors should ensure they have appropriate confidentiality procedures in place.**

Mitigating regulatory risk from joint industry innovations

Bringing innovative products and services to market in Industry 4.0 and the sustainability space requires closer collaboration between companies than ever before – whether they are actual or potential competitors, suppliers or distributors. These ties raise innovative antitrust concerns compared to the theories of harm that the FTC and DOJ have investigated in more traditional sectors in the past.

> **Increased scrutiny from antitrust agencies is now a fact of life. Businesses must take care and affirmatively manage potential antitrust risks in their innovation projects – particularly those that involve collaborations with actual or potential competitors, suppliers or distributors.**

For example, the DOJ has opened an investigation into whether automobile manufacturers violated antitrust law by agreeing to meet California's emissions regulations, and DOJ Assistant Attorney General Makan Delrahim has emphasized that collusion among implementers of technological standards can push down patent licensing rates, thereby diminishing incentives to innovate.

Investigations such as these carry a serious risk of chilling dynamism in rapidly advancing technological spheres, as there is often no legal precedent or regulatory guidance to provide comfort that a collaborative effort can be structured in a way that is compliant with competition law. This is particularly true if competition regulators look to challenge R&D efforts as collusive under a theory that an even higher level of innovation could have been achieved than resulted from the collaboration.

Antitrust in an era of political fragmentation

The past year has already signaled a shift away from globalization in international politics. The US's volatile trade relationships with China and the EU – and the paralysis of the WTO – have undermined world trade, while a renewed focus on the impact of international conglomerates on local markets has challenged the orthodoxy of the global perspective of recent years.

Shifting political dynamics have also contributed to questions about whether competition authorities should focus on consumer fairness and industrial policy concerns in their investigations and decision-making. Assistant Attorney General Makan Delrahim has stood behind the consumer welfare standard as the lodestar of antitrust enforcement, while Federal Trade Commissioner Rohit Chopra has tied the US's future economy and democracy to its ability to restore free and unfettered competition.

> **Over past 5 years, the value of Chinese investment in sensitive sectors such as automotive, energy, finance, health and IT in the US has fallen by 69 percent.**
>
> Source: Rhodium China Investment Monitor

At the same time, as the US presidential campaign switches into high gear, we can expect candidates from both sides of the divide to continue their focus on consumer welfare. Companies should prepare themselves for increased scrutiny (both in a merger control context and via wide-ranging sector inquiries) to feed into policy updates or enforcement action. As national approaches diverge, international coordination will become even more critical to maximize companies' chances of success.

> In election year, expect continued scrutiny of high-tech industries and an intense focus on pharmaceutical pricing and other healthcare costs.

Freshfields

Navigating foreign investment rules

CFIUS and other international frameworks

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National security and commercial technology innovation – convergence and conflict

The race to lead in artificial intelligence, robotics, blockchain, gene-editing and other emerging technologies not only has potentially far-reaching economic implications, but also, from the US government's perspective, significant consequences for future national security. Artificial intelligence (AI), for example, may be the key to deriving value from the massive amounts of consumer data that many companies now collect, but it may also be vital to analyzing huge volumes of sensor data for intelligence purposes – by the US or its adversaries. The drama surrounding Huawei and 5G (which will get worse before it gets better) has drawn the tension between commercial and national security interests into stark relief. Some of the companies most impacted by the US government's decision to put Huawei on the Department of Commerce's (DOC) "Entity List" are US businesses with significant semiconductor sales to Huawei.

To manage these risks, the US government is working to establish a regulatory framework for sharing these technologies across borders, without stifling the development of new products and capabilities that may be key to ensuring the US's future national security advantage. This is a particularly challenging balance to strike, and it is not yet clear whether the government has the ability or the will to do so. Among the tools it is using to achieve this goal are export controls and foreign investment review. DOC, which administers the US dual-use export control system, is revising its regulations to impose additional controls on strategic emerging technologies. For example, it announced in January 2020 relatively narrow new controls on geospatial AI software, but it remains to be seen whether it will issue a more sweeping rule as well. Rules implementing the 2018 Foreign Investment Risk Review Modernization Act (FIRRMA), the most significant reform of the Committee on Foreign Investment in the United States (CFIUS) process in 30 years, take effect in February. FIRRMA subjects a wider breadth of foreign investment – particularly in strategic emerging technologies and companies – to CFIUS review. It will be imperative for boards to track these developments as they will have major consequences for how investments are made, where investments can be sourced, exit strategies, cross-border collaboration, who can license or acquire technology, who can be employed and a host of other functions that may be important to the development of future technologies.

> **Rules implementing the 2018 Foreign Investment Risk Review Modernization Act, the most sweeping reform of CFIUS in 30 years, will become final in February.**

China is not on the friends list, and that may not change despite "phase one" trade deal

The President's rhetoric and tweets – and their timing – might understandably lead one to believe that the aggressive steps taken by CFIUS against Chinese investment in the US, and other pressure on China connected to technology issues like the Huawei designation, are really part of ongoing attempts to reduce the trade deficit with Beijing.

In reality, however, US government concerns around China's acquisition of technology – whether through investments in US companies, forced joint ventures in China, or the theft of intellectual property – started in earnest in the last administration and have merely accelerated under the current presidency. Furthermore, even on Capitol Hill there is relative consensus among Democrats and Republicans that China poses a leading, if not the foremost, long-term threat to US national security. Thus, while President Trump may use national security issues as leverage in trade discussions, the successful inking of the "phase one" trade deal is not likely to make these security concerns go away. Against this backdrop it is important that boardroom discussions on the implications of China-US relations be nuanced and distinguish between actions that are tactical moves to gain advantage in trade talks from those that are likely to persist in the long term.

China, for its part, is also in this for the long-haul. The more the US exerts pressure on Beijing, the more China becomes motivated to develop its own capabilities to break its dependence on the United States for technology. And in response to moves like the Huawei listing that China views as punitive, it, too, has threatened to act against foreign companies that are deemed "unreliable entities." As a key market and manufacturing outpost for many US businesses, these developments only add to long-term unpredictability.

It is important that boardroom discussions on the implications of China-US relations be nuanced and distinguish between actions that are tactical moves to gain advantage in trade talks from those that are likely to persist in the long term.

These trends are global, and the tools do not always discriminate between friend and foe

The drive to consider how to control emerging technologies and to expand foreign investment review processes – and concern related to the challenge posed by Chinese overseas investment – is not limited to the United States. In the UK, legislation for a standalone foreign investment review regime has been proposed for this year. New EU rules will be applicable from October 2020 that provide for a cooperation mechanism between member states and the European Commission in screening direct investments from outside the EU on public security grounds. France and Germany, too, have recently revised their foreign investment laws, while Japan is in the process of doing so, and even Israel is considering a law. (Not surprisingly, this activity has prompted China to establish its own foreign investment review process.) Today, more than 100 jurisdictions now have laws that allow the review of foreign investment on security or public interest grounds. Typically, these regimes apply to all foreign investors – not just those from particular jurisdictions – although they may be more lenient with respect to some. There are a number of transactions involving European-based purchasers that have been caught up in extended US reviews and vice-versa, despite the historical security cooperation among these jurisdictions. As the proliferation of foreign investment regimes is resulting in longer lead times and greater execution uncertainty, those risks need to be factored into transactional decisions even among allied nations.

Practical guidance for boards

1. Directors and senior management should understand the company's national security profile (goods, services, and capabilities) and how government national security regulatory interests may limit future commercial opportunities.
2. Consider the national security profile of your primary customers and suppliers and how government action against any one of them would impact your operations.
3. Consider foreign investment review risk early on in any cross-border deal.
4. Think about this globally, not just in connection with operations in the United States. US investments even in "friendly" countries could get caught up in investment reviews. Meanwhile, US companies operating in China may bear the cost of the growing economic de-coupling of the US and China, driven in part by technology foreign policy.

Freshfields

Technology and business

Cybersecurity, data and regulatory risk

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2019 saw major developments in the enforcement of privacy and cybersecurity laws worldwide, and 2020 promises much the same. Companies should expect to see more enforcement activity relating chiefly to cybersecurity and transparency about privacy practices – particularly in Europe – together with a sharp intersection between privacy and competition law. They should also anticipate more jurisdictions adopting privacy laws inspired by – though not necessarily following – the EU's General Data Protection Regulation (GDPR).

Enforcement trends: fines rise as authorities flex their muscles

Last year saw the UK Information Commissioner's Office (ICO) propose major fines against an airline and a hospitality chain arising out of cybersecurity incidents related to customer data. These were among the first fines put forward under the GDPR and provided important indications as to how European data protection authorities would approach the calculation of penalties. The fines were also some of the first examples of the GDPR's "one stop shop" enforcement mechanism, through which a data protection authority in one EU country can act, in all intents and purposes, on behalf of the entire bloc.

One of these cases also raises the prospect of data protection authorities more closely scrutinizing the level of cybersecurity and data privacy due diligence carried out on transactions, including as part of post-acquisition integration. We also see European fines continuing to be levied directly on the US HQs of multinational businesses (even where those companies have a significant footprint outside the US) which may be a good reason for corporates and financial investors to reflect on how they structure their data operations and holdings overseas.

The US, too, got in on the act, with the Federal Trade Commission (FTC) handing out several large fines relating to the protection of children's personal data.

In 2020 these trends are set to continue, although fine calculation under the GDPR is likely to become more predictable with several data protection authorities promising to publish guidance. And we can expect further strident enforcement in both Europe and the US beyond existing focus areas such as cybersecurity, children's data and transparency, with competition a likely nexus.

> **"In 2020, the calculation of fines under the GDPR is likely to become more predictable, with several data protection authorities promising to publish guidance.**

2019 saw antitrust regulators promising to use competition law to regulate the collection and use of personal data. This shift is potentially fundamental, as it represents an effort to block certain data collection and uses in themselves, rather than merely regulate how those practices are disclosed or how data is secured.

Major decisions: further challenges expected to EU/US data transfers

In December 2019 the EU Advocate General issued an opinion recommending that the Court of Justice of the EU uphold the validity of the "standard clauses", key mechanisms businesses use to transfer personal data from Europe to the US. Max Schrems, a notable privacy advocate, had challenged them on the grounds that they provide inadequate protections for Europeans in light of US government surveillance programs. In doing so, Mr. Schrems also questioned the validity of the EU-US Privacy Shield, another critical framework for transferring data across the Atlantic.

Mr. Schrems had previously sunk the Privacy Shield's predecessor, Privacy Safe Harbor, although this time the Advocate General avoided ruling. Nonetheless, the opinion (if confirmed) leaves open other avenues for the Privacy Shield to be challenged. In 2020 we can expect to see additional attacks on transfers of data to the US, together with an EU initiative to revamp its standard clauses in line with the GDPR. Any of these developments could fundamentally change how companies transfer European personal data outside Europe's borders.

Legislation: is this the year we see movement on US privacy law?

There are likely to be major developments in privacy laws around the world in 2020, with more jurisdictions set to adopt regimes inspired by the GDPR model.

Brazil's privacy legislation modelled on GDPR – the LGPD – comes into effect in August 2020. Likewise the implementing regulations and technical standards for China's cybersecurity framework (with its onerous data localization requirements), and the associated Cybersecurity Multi-level Protection Scheme may also be finally brought in this year.

The biggest movement, however, could be in the US. The California Consumer Privacy Act (CCPA) came into force on January 1, 2020, with enforcement starting six months later. Some aspects of the law are familiar from GDPR and other privacy regimes, such as the requirement for transparency around data practices and the granting of rights to Californian data subjects to access, control and

We can expect further attacks on transfers of data from Europe to the US, which could fundamentally change how companies transfer European personal data outside Europe's borders.

delete their personal data. But unlike previous laws, the CCPA tends to focus on the "sale" of data. Its definition of "sale" is unconventional, confusing and broad, and depending on how it comes to be interpreted by the Attorney General and the courts, may pose major headaches for business.

Even as companies work to implement the CCPA as it stands, the ground is already shifting. Alastair MacTaggart, a major mover behind what became the CCPA, is promoting a ballot measure in California's 2020 election that would create a California Privacy Protection Agency and impose additional requirements around targeted advertising, children's data, automated decision-making by businesses and the use of personal information by political campaigns. Meanwhile, legislators in Washington state have proposed laws falling somewhere in between the CCPA and GDPR; after early versions failed to pass the legislature, a new proposal is making the rounds that includes ad targeting and facial recognition among its focus areas.

We may also see movement at the federal level in 2020. Democratic and Republican senators in November 2019 introduced competing proposals for a new federal privacy law, both of which would adopt key elements of GDPR/CCPA including by introducing transparency requirements and providing data subjects with rights over their data. Both bills also agreed on who would enforce the law (the FTC), but where they did not agree was on whether to provide a private right of action and whether to pre-empt state laws such as the CCPA.

In December the House Energy and Commerce Committee introduced a bipartisan bill adopting the points of agreement, while avoiding the areas of divergence. Whether any of these bills make it into law remains to be seen, but the flurry of activity and apparent cross-party convergence around certain themes seem to presage faster movement on a US-wide privacy law than had previously been expected.

We may see movement on a US federal data protection law, with cross-party consensus on some aspects seeming to suggest faster progress towards a US-wide statute than previously expected.

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SEC disclosure obligations

Continuing focus on technology, IP and cybersecurity risks

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The SEC has recently issued new guidance on US reporting companies' disclosure obligations in relation to technology, intellectual property and cybersecurity risks arising specifically from their international operations. The guidance focuses on companies conducting business in countries that do not afford the same protections to corporate proprietary information, including intellectual property and trade secrets, as those available in the US.

The SEC presented a list of questions that reporting companies should answer when assessing risks in this area and their potential impact on present and future operating plans. They include the following.

1. **Foreign operations susceptible to theft**
   Do you operate in an industry or foreign jurisdiction that has caused, or may cause, you to be particularly susceptible to the theft of technology or intellectual property or the forced transfer of technology?
2. **Storing technology abroad**
   Do you store technology or intellectual property locally in a foreign jurisdiction?
3. **Required suppliers**
   Are you required to use equipment and services provided by a state actor?
4. **License agreements**
   Have you entered into patent or technology license agreements with a foreign entity or government that provides such entity with rights to improvements on the underlying technology or rights to use the technology following the licensing term?
5. **Controlling shareholder requirements**
   Are you subject to a requirement that foreign parties must be controlling shareholders or hold a majority of shares in a joint venture in which you are involved, or are you involved in a joint venture that is subject to foreign ownership restrictions or requirements that a foreign party retain certain ownership rights?
6. **Conditions to business**
   Have you been required to yield rights to technology or intellectual property as a condition to conducting business in or accessing markets in a foreign jurisdiction?
7. **Limited enforcement rights**
   Are you operating in foreign jurisdictions where the ability to enforce rights over intellectual property is limited as a statutory or practical matter?
8. **Relocation due to foreign conditions**
   Have conditions in a foreign jurisdiction caused you to relocate or consider relocating your operations to a different host nation?
9. **Controls**
   Do you have controls and procedures in place to adequately protect technology and intellectual property from potential compromise or theft?

The SEC emphasized that companies that conduct business in certain foreign jurisdictions, house technology, data and intellectual property abroad, or license technology to joint ventures with foreign partners, may have more significant exposure. As a prerequisite to engaging in business in a particular jurisdiction, reporting companies may be required to submit to contractual or regulatory provisions that place their intellectual property at risk. Examples of potentially difficult situations cited by the SEC include the following.

1. **License agreements**
   Patent license agreements pursuant to which a foreign licensee retains rights to improvements on the relevant technology, and the right to continued use of technology or intellectual property after the patent or license term of use expires;
2. **Foreign ownership restrictions**
   Foreign ownership restrictions, such as joint venture requirements and foreign investment restrictions that potentially compromise control over a company's technology and proprietary information.
3. **Idiosyncratic terms favoring foreigners**
   The use of unusual or idiosyncratic terms favoring foreign persons, including those associated with a foreign government, in technology license agreements.
4. **Regulatory requirements**
   Regulatory requirements that restrict the ability of companies to conduct business, unless they agree to store data locally, or comply with local licensing or administrative approvals that involve the sharing of intellectual property.

While there is no specific SEC line item that requires disclosure of information relating to the threat of cybersecurity or intellectual property breaches, the SEC has made it clear through this guidance, and other guidance previously issued, that it believes there may be a heightened risk of cybersecurity and data breaches associated with international business operations. The SEC also indicated that disclosure of any material compromise or theft may be required in management's discussion and analysis, the business section, legal proceedings, disclosure controls and procedures, and the reporting company's financial statements.

Practical guidance for boards

1. Intellectual property (IP) protection and cybersecurity remains a key area of SEC focus.
2. In particular, IP and technology protection concerns arising from non-US operations are a specific area of SEC scrutiny.
3. Companies need to evaluate risks to their technology and IP arising from foreign operations, joint ventures and license agreements and potentially increase the disclosure of these risks where material.
4. Reporting companies must disclose the occurrence of a material cybersecurity compromise or theft of intellectual property or data.
5. Heading into annual reporting season, reporting companies should review the questions provided by the SEC in this guidance when preparing their disclosure.
6. Additional disclosures regarding risks to intellectual property and technology could potentially be required in the annual report's MD&A, business section, legal proceedings section, description of the disclosure controls and financial statements.

Freshfields

Taxing the digital economy

What shifting rules mean for global businesses

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In 2020 there are likely to be important developments in the way many countries tax cross-border business. In particular, US corporations that provide goods and services to European consumers through the internet, rather than a local presence, are likely to face increased foreign taxation.

There has long been a consensus among developed countries – implemented through bilateral tax treaties – that companies should not be subject to tax in a country unless they have a physical presence there. This model functioned well in a global economy where most services were performed locally and the value of goods derived mainly from tangible assets and "bricks and mortar" facilities. However, many countries are finding the results of this system unacceptable in a modern context, where services can be provided remotely via the internet and the value of goods is often dependent on intangibles with no physical location.

> **"Market" countries are often unable to tax the profits multinational groups derive from sales in their jurisdictions. In response they have begun to unilaterally impose new levies.**

Countries act to tax digital goods and services

Under the old model, "market" countries – that is, economies that are net consumers of remotely provided services and goods whose value depends on intangible assets – often find themselves unable to tax the profits that multinational groups derive from sales in their jurisdictions. In response, they have begun to respond by unilaterally implementing new levies.

For example, in July 2019 France enacted a new digital services tax (DST) of 3 percent on revenues from "digital services" earned by large multinational companies operating within its borders. In 2015, the United Kingdom adopted a 25 percent "diverted profits tax" (DPT) on profits that the UK tax authorities determine to have been diverted from the UK through "contrived arrangements" that erode the country's tax base. Elements of the 2017 US tax reform were also aimed at transactions that shift profits from doing business in the US to related foreign parties. In particular, the "base erosion anti-avoidance tax" (BEAT) limited US companies' deductions for base-eroding payments to non-US affiliates, effectively insuring some US tax on the profits used to fund these payments.

The OECD's "two pillar" model

To forestall such unilateral action by individual countries, the Organization for Economic Cooperation and Development (OECD) and the G20 have been working to build a new consensus model for international taxation. In 2019, the OECD engaged in a major project to develop an international consensus on new principles for the taxation of multinational enterprises. Its proposals fall into two broad categories, known as Pillar One and Pillar Two.

Pillar Two contains proposals for global anti-base erosion taxes, that is, new rules to prevent tax evasion and ensure that profits are taxed at a minimum level in at least one jurisdiction. It proposes a minimum tax similar to the new US levy on "global intangibles low-taxed income" (GILTI), and a rule denying deductions for certain cross-border payments comparable to BEAT.

The more far-reaching changes however are in Pillar One, which proposes a new taxing right not based on physical presence. Under this system, a portion of a multinational group's "deemed residual profit" would be taxable in market countries, regardless of the group's physical presence there. The amount subject to tax would be determined based on a pre-agreed formula (e.g. a percentage of sales). The deemed residual amount would be profits above a baseline level. However, most of the detail of Pillar One – including, critically, the methods for determining deemed residual profit, baseline profit and the scope of applicability of the proposals – is yet to be determined.

> **"The US has reacted strongly against the imposition of some unilateral tax measures, imposing trade sanctions on France in response to its Digital Services Tax.**

Practical guidance for boards

To respond to unilateral measures that have already been taken, as well as to anticipate the effect of implementation of OECD proposals, US-based multinational groups should do the following.

1. Evaluate how unilateral tax measures, such as the French DST or UK DPT, affect their business models and international structures.
2. Reconsider how their global structures for marketing and distributing goods and services may be affected by proposed OECD rules.
3. Consider whether a foreign tax credit against US tax will be allowed for new foreign taxes, and how both the unilateral measures and the OECD proposals described above could otherwise affect their US tax liability.

US approaches proposed changes warily

The US is actively participating in OECD discussions on the Pillar One and Pillar Two proposals, but appears to be approaching any potential changes warily. It has also reacted strongly against the imposition of some unilateral tax measures, for example imposing trade sanctions on France in response to its DST. The risk of such uncoordinated responses to unilateral action by market countries is driving international cooperation. Thus, the OECD intends to finalize an agreed multilateral approach by the end of 2020. This will not have the force of law, but is likely to strongly influence law-making in many countries.

Cloud computing: how US rules are adapting

US rules for taxing cross-border transactions have similarly struggled to keep up with the digital economy. The increased importance of e-commerce and intangible assets make it easier for multinational groups to determine where their income is treated as earned, facilitating the shifting of profits outside US taxing jurisdiction. In partial response, the government substantially revised its international tax rules in 2017 as part of the Tax Cuts and Jobs Act (TCJA), adopting new provisions such as the global intangibles low-taxed income (GILTI) rules, foreign-derived intangibles income (FDII) rules and the base erosion anti-avoidance tax (BEAT). Each of these mechanisms addresses the incentives for multinational groups to move intangibles and profit-generating functions offshore.

The US Treasury has recently proposed new rules to help protect US taxing jurisdiction over income from an increasingly important form of e-commerce: cloud computing. Sourcing rules are critically important in the US tax system, and these provisions would change how the US tax system determines whether cloud computing income is treated as "US source" rather than "foreign source". For foreign taxpayers, income is generally only taxed if it is treated as "US source", although for US taxpayers (who are in theory subject to tax on even non-US source income), sourcing rules are also important. If their income is treated as foreign source, creditability of foreign taxes is increased and the burden on income earned through foreign subsidiaries is reduced.

Proposed rules cover broad range of digital services

Historically, the US tax system has applied different source rules to income from services, sales, leases and use of intangible property. These mechanisms do not work well for e-commerce transactions (which often do not fit into one category alone), making determination of source unclear or easy to manipulate.

The proposed cloud computing regulations would provide new rules for determining the source of income from digital content and transactions. What constitutes a "cloud computing transaction" is broad and includes not only infrastructure as a service (IaaS), software as a service (SaaS) and platform as a service (PaaS), but also streaming digital content (including books, movies, music and games), access to online databases and downloads of digital content.

> **"What constitutes a "cloud computing transaction" under the new rules is broad, covering everything from infrastructure as a service to streaming digital content.**

The proposed rules do not change the importance of classifying a transaction in working out what source rules apply, but they do provide new guidance for making that classification. They determine whether transactions are leases or services with a multi-factor test; IaaS and PaaS would generally be classified as leases, whereas digital streaming or access to digital content would generally be treated as a service.

Plan changes tax profile of non-US businesses

Income from such leasing would be US source where property is used in the US; the source of services income is left unclear but under existing law it would presumably be non-US if the services are provided outside the US. However, the most important of the new rules in practice would be the one that applies where digital content is treated as sold (rather than leased or provided as a service); the sale will be deemed to occur where digital content is downloaded (i.e. where the end-user's device is located).

Thus, non-US businesses that offer downloadable content to US customers will have US source income and thus potentially be subject to US tax. While treaty-eligible US sellers may be unaffected so long as they lack a physical presence in the United States, many non-US providers of digital content will not be eligible for treaty relief. As a result, this change will increase tax on offering downloadable content to US customers.

Practical guidance for boards

The cloud computing regulations are still only proposed and are not guaranteed to become law in their current form; the US Treasury has requested comments and likely will revise the rules in response before finalizing them. In particular, the sourcing of streaming digital content is an area where further guidance is expected. Multinational businesses should:

1. examine how the proposed regulations could affect their business, including how cloud computing transactions generate revenue and how digital services are used by the business;
2. reconsider tax structuring for group entities that consume or provide digital services; and/or
3. consider filing comments on the proposed regulations.

The most important of the new rules may mean non-US businesses that offer downloadable content to US customers will be subject to US tax.

Freshfields

Debt forecast

Libor transition, creditor risk and flexible covenants

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Libor switch presents opportunities

In 2021 the London Interbank Offered Rate (Libor) is set to be discontinued. The benchmark establishes an average rate at which banks are willing to borrow from one another, and is used to calculate interest and other payments in roughly $300tn of financial contracts around the world.

Financial regulators decided to phase out Libor primarily because there are almost no borrowings between banks in Libor any more, and because the institutions that helped set it were found to have been rigging a proposed rate in their favor. In its place will come alternative benchmarks in each of the five Libor currencies (dollars, euro, sterling, Swiss franc and yen), although progress towards transition remains patchy across the various markets and the effort is not coordinated on a global basis.

The Libor replacement process will affect any business that borrows debt with a floating interest rate, or which has derivative instruments underpinned by Libor or its equivalents. These companies will need to negotiate replacement reference rates with their lenders and hedge providers and may need to amend their debt contracts. However, those that act now will ensure an orderly transfer ahead of time, save money and ultimately reduce their risk of disputes with lenders in transitioning to a new rate.

Sustainability offers route to lower costs

Greater focus on sustainable practices and disclosure is allowing companies to reach new pools of equity capital while cutting debt costs.

> **SLLs offer issuers lower margins when they meet certain ESG criteria; further evidence that sustainability has become a driver of genuine bottom-line growth.**

The green financing market is growing year-on-year, with almost $36bn of 'sustainability linked loans' (SLLs) issued in 2018 alone. The number of money market funds that incorporate environmental. social and governance (ESG) metrics is also expanding rapidly, with assets rising 15 percent to $52bn in the first half of 2019, according to analysis from Fitch Ratings. While only a fraction of the total money market sector, their growth reflects rising demand from investors for sustainable products.

SLLs offer issuers lower margins when they meet certain sustainability criteria, providing further evidence that sustainability has moved beyond corporate social responsibility to become a driver of real bottom-line growth.

To read more on how to access these new pools of ESG capital, read our report produced in association with the Rustandy Center for Social Sector Innovation at the University of Chicago, and the London School of Economics and Political Science.

How to mitigate creditor risk

Boards of companies with debt traded on the syndicated markets need to be mindful of their creditor base in the year ahead.

There is a rising risk of creditors who hold short positions in loans and bonds in the credit default swaps market pressuring borrowers to declare defaults. Boards can protect against this threat by ensuring that their company has robust consent rights over trades, and by negotiating provisions in debt agreements that limit voting rights and/or the right of such creditors to declare defaults after a certain time period has passed. These provisions prevent or deter such creditors from buying into a syndicate in the first place.

However any defensive measures must be used with care, given that they have the potential to raise the price of future debt.

Revisit debt agreements to enhance competitiveness

Finally, companies should take a fresh look at any credit documentation based on forms that are more than a year or two old, particularly if they have near-term strategic priorities that require investment or want to enhance their ability to respond to the unexpected.

In general, borrowers in the debt markets have been able to agree ever-looser covenants in the years since the financial crisis, and at present it is possible to negotiate flexibility with lenders to avoid seeking waivers and consents in the future. Revisiting past agreements can therefore help position companies to be more competitive when responding to market opportunities and challenges.

There is a rising risk of creditors who hold short positions in loans and bonds in the credit default swaps market pressuring borrowers to declare defaults.

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