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A Review of the STADA Arzneimittel Proxy Contest and the Activism Landscape in Germany

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Editor's note: Steve Wolosky is partner and chair of the Activist & Equity Investment Practice at Olshan Frome Wolosky LLP. This post is based on an Olshan publication by Mr. Wolosky, Andrew Freedman and Ron Berenblat. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here).

Active Ownership Capital ("AOC"), an activist investment company that takes minority positions in undervalued small to mid-size publicly traded companies in Western Europe and the Nordics, recently won a small, but significant, victory in a proxy battle it waged against STADA Arzneimittel AG ("STADA" or the "Company"), a publicly listed pharmaceutical company based in Germany. AOC, the owner of between 5% and 10% of the capital stock of STADA, sought to replace multiple members of the Company's Supervisory Board at its 2016 Annual General Meeting ("AGM"). While AOC was only successful replacing the Chairman of the Supervisory Board at the AGM, this event garnered significant media attention given how rare proxy contests are in Germany. A review of the STADA situation reveals that there may be various avenues available to a shareholder holding a relatively small ownership interest in a German listed corporation to influence management and, if necessary, to run a proxy contest.

AOC believed that STADA was well-positioned to take advantage of attractive end markets for its drugs and had great potential to grow the business and create value for its stakeholders. However, AOC believed STADA was underperforming its peers during its ongoing transformation from a local generics player that primarily sold its products to German pharmacies to a global pharmaceutical company with an international client base. AOC believed this underperformance was attributable to a Supervisory Board that lacked the competencies necessary to lead the Company during this period of growth and internationalization. AOC also criticized the Supervisory Board for poor oversight and mismanagement and described its corporate governance regime as "one of the worst we have ever seen in Germany." Specifically, AOC accused the Supervisory Board of approving excessive management pay, supporting ill-advised acquisitions, lacking independence and even fostering a culture of "cronyism." As a result, AOC believed the Supervisory Board needed to be refreshed and strengthened with more qualified candidates who could address the challenges facing the Company.

Germany’s Two-Tiered Board Structure

German listed corporations have never been prime targets of shareholder activists due to their mandatory two-tiered board structure. Under the German Stock Corporation Act (Aktiengesetz), all publicly listed corporations have a Management Board (Vorstand) comprised of executive directors and a Supervisory Board (Aufsichtsrat) comprised of non-executive directors, unless the corporation has elected to be incorporated under European Company law in which case a single-tier board system may apply. The Management Board oversees the day-to-day business and operations of the corporation and formulates and executes the corporation’s business strategy. The Management Board reports to the Supervisory Board on its intended business policy and plans, the corporation’s profitability, the state of the business and material transactions, all in accordance with a timetable specified in the statute. The Supervisory Board appoints the members of the Management Board for a term not exceeding five years (which term may be renewed provided each renewal does not exceed five years). The Supervisory Board is charged with monitoring the Management Board’s activities on behalf of the various constituents it represents. The Supervisory Board has the statutory right to dismiss members of the Management Board but only for cause.

The members of the Supervisory Board are elected by the shareholders. However, the employees will have the right to elect a portion of the Supervisory Board if the corporation is also subject to a separate body of codetermination laws (Mitbestimmung). If the codetermination laws apply, the employees of the corporation have the right to elect one-third of the members of the Supervisory Board if there are between 500 and 2,000 employees based in Germany or one-half of the members of the Supervisory Board if there are more than 2,000 employees based in Germany. The corporation’s governing documents and the codetermination laws may reserve for other groups of shareholders or other constituents (such as labor unions and debt holders) the right to elect a specified proportion of the Supervisory Board. Shareholder representatives on the Supervisory Board may be removed by the shareholders at a shareholders meeting by a majority of not less than 75% of the votes cast, unless the governing documents of the corporation provide for a different majority threshold or other requirements. At a shareholders meeting where shareholder representatives on the Supervisory Board are up for election, any shareholder may nominate a competing slate of candidates and the shareholders will be given the opportunity to vote for the competing slate at the meeting as long as shareholders holding at least 1/10th of the share capital represented at the meeting so request.

While the Supervisory Board’s purpose is to provide oversight and to report to its constituents, it can and does exert influence over the Management Board’s decisions and actions. The Supervisory Board appoints the members of the Management Board and has the right to appoint its chairman. The Supervisory Board determines the compensation of the members of the Management Board. If not specified in the governing documents of the corporation, the Supervisory Board has the obligation to determine which types of corporate transactions may only be entered into with its consent. The Supervisory Board also has the right to inspect the books and records of the corporation and call a shareholders meeting.

AOC Proposes Replacement of Supervisory Board Members

On May 9, 2016, AOC announced that it had submitted to STADA a motion for the agenda for the AGM, originally scheduled for June 9, 2016, to remove and replace five of nine Supervisory

Board members. STADA's Supervisory Board is comprised of nine members, of which six are shareholder representatives and three are employee representatives. AOC sought to replace five of the six shareholder representatives with its five candidates. AOC's five candidates were comprised of four independent nominees and Klaus Röhrig, a principal of AOC. The five existing Supervisory Board members AOC sought to replace served tenures ranging from 33 to 13 years. According to AOC, a stronger Supervisory Board with broad and relevant expertise in the pharmaceutical and healthcare industry as well as management, corporate governance, finance and law would be a first step in addressing the challenges STADA faced as a growing global pharmaceutical company.

It is important to note from a mechanics standpoint that the members of STADA's Supervisory Board were not scheduled to stand for reelection at the AGM. The term of all shareholder representatives serving on the Supervisory Board was not set to expire until the conclusion of the 2018 Annual General Meeting. Rather than waiting until the 2018 Annual General Meeting to nominate a competing slate of director nominees, AOC sought to remove and replace members of the Supervisory Board at the upcoming AGM. Specifically, AOC exercised its statutory right as a shareholder of in excess of 1/20th of the outstanding share capital to include on the Company's agenda for the AGM proposals to remove shareholder representatives from the Supervisory Board prior to the completion of their term and to fill the vacancies created by such removal with AOC's director candidates.

AOC and STADA Enter Into Agreement Revising AOC Resolutions to Replace Directors

Shortly after AOC submitted its motion for the agenda to replace five of the nine Supervisory Board members, STADA and AOC entered into a written agreement clarifying the resolutions that the Company would include on the agenda for the AGM. The revised resolutions the Company included in a supplement to the agenda for the AGM provided that AOC was now proposing to replace three (instead of five) of the nine Supervisory Board members. The AOC slate of three director candidates still included Mr. Röhrig. It is not clear why AOC agreed to reduce the size of its slate as it had the statutory right to remove and replace five directors as initially proposed. We believe AOC may have agreed to reduce the size of its slate in order to appear less combative from an optics standpoint and garner support from other shareholders who may have believed five seats was overreaching.

Nevertheless, AOC downplayed the agreement, stating by press release that the revised resolutions represent "good compromise between strengthening the Supervisory Board with broader and more relevant expertise and ensuring continuity in the Supervisory Board in the interest of the company." In a more self-serving press release, the Company asserted that it decided to voluntarily accept the agenda amendment, "within the scope of its discretionary powers," and that the Management Board "sees its obligations first and foremost in the well-being of the company." The Company also stated that it accepted the revised resolutions in order to avoid costly litigation in the event AOC commenced legal proceedings or an attempt to convene an Extraordinary General Meeting to replace the Supervisory Board members. STADA affirmed that the AGM would still be held on June 9, 2016 and stated, "[i]t is now up to the shareholders to vote on the motion from Active Ownership Fund …" Dr. Martin Abend, the Chairman of the Supervisory Board and the sole incumbent director who would eventually be removed by AOC at the AGM, concluded, "we on the Supervisory Board had already begun to look at questions related to the succession planning process some time ago …" Dr. Abend's remark was a harbinger of the Company's next strategic move.

STADA Shifts Gears—Postpones AGM and Accelerates Timetable for Election of Supervisory Board Members

On May 22, 2016, just ten days after STADA publicly stated that "it would like to ensure a quick decision in this matter" and that the AGM would be held as planned on June 9, 2016, the Company changed strategic course. STADA announced that it would accelerate by two years the originally planned election at the 2018 Annual General Meeting of at least three new Supervisory Board shareholder representatives and these candidates would be proposed for election at the upcoming AGM. In other words, of the six shareholder representatives on the Supervisory Board whose terms were scheduled to expire at the conclusion of the 2018 Annual General Meeting, at least three of them would cease to serve on the Supervisory Board upon the conclusion of the upcoming AGM and new proposed shareholder representatives would stand for election at the AGM to fill the vacancies. The new shareholder representatives up for election at the AGM would serve for a term of five years. The candidates would be identified by a nomination committee of the Supervisory Board with the support of external advisors and pursuant to a structured selection process based on a clearly defined set of criteria.

STADA's stated purpose of realigning the Supervisory Board was to bolster the Company's international growth strategy for its products. However, given the timing of the announcement, we believe this initiative was intended as a defensive measure to address AOC's publicly stated concerns with the existing members of the Supervisory Board and to put forth candidates with attributes that could match the breadth of experience, expertise and independence of AOC's candidates. The AGM was postponed to August 26, 2016, purportedly "to ensure an orderly and transparent process for the selection of candidates and for the preparation of the election of the new Supervisory Board members."

Around five weeks later, on July 1, 2016, AOC issued a press release announcing that Dr. Abend rejected AOC's proposal that it be actively involved in the drafting of the selection criteria and/or selection process for identifying the new shareholder representatives proposed to be elected to the Supervisory Board. As a result, AOC would submit to the Company a joint shareholder proposal to elect its own slate of new Supervisory Board candidates and it had engaged executive search firm Spencer Stuart to assist AOC with the selection process. AOC also accused STADA of breaching their written agreement with respect to the AGM by postponing the AGM and failing to allow shareholders to vote on AOC's revised resolutions proposing to elect three new Supervisory Board members. AOC stated that it no longer had "any faith in the ability of the current management to conduct the process to select new candidates to propose to the shareholder meeting on August 26, 2016 in a transparent, due and proper manner that serves the best interests of the company, its shareholders, and employees." AOC then invited, through an appeal on a web-based shareholder forum known as Aktionärsforum, significant shareholders to participate in AOC's selection process.

Shortly thereafter, STADA announced that it had completed its selection process and disclosed the names of four candidates for the Supervisory Board who would be proposed for election at the AGM and the four current members they would be replacing. As proposed, four of the six shareholder representatives on the Supervisory Board would be newly elected at the AGM. Dr.

Abend and Carl Ferdinand Oetker were the two remaining shareholder representatives on the Supervisory Board who were slated to continue to serve out their current terms through the 2018 Annual General Meeting. The Company's new candidates, two of whom were women, were comprised of seasoned veterans with international expertise in the pharmaceutical, healthcare and other industries. STADA reiterated that the structured process for this personnel realignment two years earlier than planned was intended to meet the requirements of the "strategic development and internationalization" of the Company. STADA also touted the diversity of its slate, highlighting the fact that one-third of the Supervisory Board would be comprised of women if all the new candidates were elected at the AGM.

STADA Proceeds With AGM—AOC Presses on With Election Contest

On July 20, 2016, STADA released its notice and agenda for the rescheduled AGM, which now called for the election of its four new proposed shareholder representatives to the Supervisory Board for a five-year term. In the press release announcing the issuance of the agenda, in addition to promoting the virtues of its slate, STADA discussed in great detail its proposal in the agenda seeking shareholder approval of the remuneration system for members of the Management Board. STADA discussed how the Supervisory Board went to great lengths to modify the remuneration system in response to specific suggestions from investors and voting rights advisors to reflect best practices. The other agenda items included the cancellation of the restricted transferability of registered shares, approval of a dividend and approval of the appointment of auditors.

A few days later, AOC announced that it had submitted counter motions and a supplementary motion for the agenda for the AGM with the objective of electing its own slate of candidates. Under the counter motions, AOC submitted a resolution effectively proposing the election of two AOC candidates as alternatives to two of the new STADA candidates. AOC would support the remaining two new candidates proposed by the Company. Under the supplementary motion, AOC submitted a resolution effectively proposing the removal of the remaining two continuing Supervisory Board members (Dr. Abend and Mr. Oetker) and the replacement of those individuals with two AOC candidates. Stated in the context of an analogous activist situation in the U.S., AOC was essentially running a dual proxy contest, the first component being an election contest with AOC seeking two of four Supervisory Board seats up for election and the second component being a business proposal submitted by AOC to remove and replace two continuing Supervisory Board members.

AOC stated that its four new candidates were selected by Spencer Stuart with the input of significant shareholders who participated in the Aktionärsforum. It is not clear what impact other significant shareholders had on the selection process. However, it is important to note that with the exception of one independent candidate, the members of this new four-member slate were not the same members that comprised AOC's original five-member slate. The integrity of the selection process implemented by AOC is reflected by the significant turnover of candidates ultimately put forth by AOC and the absence of Mr. Röhrig or any other principal of AOC from the new slate. Since all six of the shareholder representatives on the Supervisory Board would be newly elected, non-incumbents assuming all four AOC candidates and the remaining two STADA candidates AOC supported were elected, AOC characterized its campaign as a full-blown effort to replace all shareholder representatives on the Supervisory Board. AOC pronounced, "The objective is to enable a comprehensive restart of the company's corporate governance by completely replacing the shareholder representatives in the Supervisory Board."

Dr. Abend Replaced After 14-Hour AGM

The AGM was held as scheduled on August 26, 2016. After the meeting, STADA announced that all four new STADA candidates were elected to the Supervisory Board. In addition, Mr. Oetker survived AOC's attempt to replace him at the meeting. However, Dr. Abend was removed from the Supervisory Board by approximately 56% of the votes cast and replaced by an AOC candidate. Notably, the proposal to approve the remuneration system for the Management Board was rejected by approximately 74% of the votes cast. After the meeting, the Supervisory Board elected Mr. Oetker as its Chairman. In his departing words, Dr. Abend took credit for the realignment of the Supervisory Board, stating "The personnel realignment of the Supervisory Board has long been a goal of mine. Today, it became a reality."

According to media reports, the AGM lasted more than 14 hours. We do not have the details on why the meeting lasted this long, however there are a few clues in STADA's press release announcing the results of the meeting and voting report publishing the results for each proposal indicating that the Company, AOC and we assume their respective advisors may have come to blows over unexpected and perhaps obscure technical and procedural matters that surfaced during the meeting.

We are speculating that there may have been some controversy with respect to the initial voting results of the election contest involving the two contested new seats up for election. It appears from the voting report that the shareholders were permitted to vote separately For or Against both the STADA candidate and the challenging AOC candidate on separate ballot items. Based on the voting report, no candidate received an affirmative vote of a majority of the votes cast. It appears separate deciding votes were taken at the meeting which allowed shareholders to vote either For the STADA candidate, For the AOC candidate or No for either (effectively Abstain). Based on these separate votes, it appears both STADA candidates prevailed over their respective AOC challengers, receiving a plurality of the votes cast. In addition, it appears AOC made counter-motions at the meeting with respect to the election indicating that AOC may have disputed the voting results at the meeting. Indeed, according to media reports, AOC is considering legal action to challenge the voting results. Finally, the voting report indicates that a motion was submitted from the floor proposing to remove Dr. Abend as chairman of the meeting (this motion was voted down), which could have been the source of additional chaos and confusion at the meeting.

Key Takeaways From STADA—Activists May Wish to Take a Closer Look at Germany

The key takeaway from our review of the STADA situation and discussions with legal practitioners in Germany is that the German Stock Corporation Act provides various avenues for an activist shareholder to seek to obtain representation on the Supervisory Board of a German listed corporation. However, an actual attempt to obtain representation on a Supervisory Board is likely to present unique challenges. From a strategic standpoint, the Supervisory Board of STADA was a prime target for an activist campaign as a majority of the Supervisory Board (six of nine members) are elected by shareholders (which is not always the case depending on the governing documents of the corporation and applicability of various codetermination laws). Although AOC ultimately (we believe for strategic reasons) targeted four of the six seats on the Supervisory Board designated for shareholder representatives, AOC had the legal right to seek to fill all six seats, which would have represented a majority of the entire Supervisory Board. Assuming AOC sought to and succeeded in replacing a majority of the Supervisory Board with a principal of AOC and like-minded independent nominees, AOC could have exerted significant influence over the Management Board through its ability to monitor and oversee the Management Board, set its compensation and appoint its members.

It is relatively easy for shareholders to seek to obtain representation on the Supervisory Board from a legal and procedural standpoint. Under the German Stock Corporation Act, in connection with a shareholders meeting where shareholder representatives on the Supervisory Board are up for election, any shareholder may nominate a competing slate of candidates and the shareholders will be given the opportunity to vote for the competing slate at the meeting as long as shareholders holding at least $1/10^{th}$ of the share capital represented at the meeting so request. In addition, shareholders owning at least $1/20^{th}$ of the share capital or a nominal value of 500,000 Euros in shares may submit business proposals, including a proposal to remove and replace shareholder representatives on the Supervisory Board, for consideration by the shareholders at the meeting. In the STADA situation, AOC did both. Shareholders owning at least $1/20^{th}$ of the share capital also have the right to compel a shareholders meeting (at the corporation's expense) provided they have held the shares for at least 90 days prior to the request. The competing slate and/or business proposals of a dissident are included by the corporation in its agenda and ballot for the meeting. There is no requirement for the dissident to file with the German authorities or disseminate to shareholders a proxy statement or similar disclosure document.

While the statutory framework applicable to German listed corporations is generally favorable from the perspective of an activist shareholder seeking representation on a Supervisory Board, one should proceed with caution before commencing an activist campaign in Germany. Unlike in the U.S., a shareholder of a German listed corporation who has submitted a competing slate or business proposal for inclusion in a corporation's agenda is not permitted to disseminate its own proxy card or ballot to collect votes in advance of the meeting. This not only makes it more difficult for a dissident to solicit votes but limits its ability to ascertain where it and the corporation stand with respect to the vote count prior to the meeting. As in the U.S., most listed corporations allow their shareholders to vote electronically without being present at the meeting. Nevertheless, in the STADA situation, it is our belief that a significant number of shares were voted in person or by representative at the meeting most likely due to the rare contested nature of the meeting. Therefore, it would be prudent to anticipate for any future proxy contest in Germany that a significant number of shares will not be voted until the day of the meeting, further limiting the dissident's transparency as to the vote count prior to the meeting.

We also cannot underestimate the importance of socio-economic, political and cultural considerations that could make it more difficult for a proxy contest to gain traction with stakeholders of a German listed corporation. In Germany, where the rights of shareholders are not supreme and the interests of various constituencies, including those of employees, are protected by various codetermination laws and represented through the two-tiered board structure, it may be more difficult to convince shareholders to be sympathetic to an activist's cause. For these reasons, it is critical to consult with counsel experienced in offshore proxy contests and a proxy solicitation firm that understands the European shareholder base and local proxy voting mechanics when evaluating a potential activist campaign in Germany.