The Corporate Governance Review

Ninth Edition

Editor
Willem J L Calkoen

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THE

CORPORATE GOVERNANCE REVIEW

NINTH EDITION

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Willem J L Calkoen

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PREFACE

I am proud to present this new edition of *The Corporate Governance Review* to you.

In this ninth edition, we can see that corporate governance is becoming a more vital and all-encompassing topic with each year that passes. We all realise that the modern corporation is one of the most ingenious concepts ever devised. Our lives are dominated by corporations. We eat and breathe through them, we travel with them, we are entertained by them, most of us work for them. Most corporations aim to add value to society, and they very often do. Some, however, are exploiting, polluting, poisoning and impoverishing us. A lot depends on the commitment, direction and aims of a corporation's founders, shareholders, boards and management, and employees. Do they show commitment to all stakeholders and to long-term shareholders, or mainly to short-term shareholders? There are many variations on the structure of corporations and boards within each country and between countries. All will agree that much depends on the personalities and commitment of the persons of influence in the corporation.

We see that everyone wants to be involved in better corporate governance: parliaments, governments, the European Commission, the US Securities and Exchange Commission (SEC), the Organisation for Economic Co-operation and Development (OECD), the UN's Ruggie reports, the media, supervising national banks, more and more shareholder activists and other stakeholders. The business world is getting more complex and overregulated, and there are more black swans, while good strategies can quite quickly become outdated. Most directors are working diligently, many with even more diligence. Nevertheless, there have been failures in some sectors, so trust has to be regained. How can directors do all their increasingly complex work and communicate with all the parties mentioned above?

What should executive directors know? What should non-executive directors know? What systems should they set up for better enterprise risk management? How can chairs create a balance against imperial CEOs? Can lead or senior directors create sufficient balance? Should most non-executive directors understand the business? How much time should they spend on their function? How independent must they be? What about diversity? Should their pay be lower? What are the stewardship responsibilities of shareholders? What are the pros and cons of shareholder rights plans and takeover defences?

Governments, the European Commission and the SEC are all pressing for more formal inflexible legislative acts, especially in the area of remuneration. Acts set minimum standards, while codes of best practice set aspirational standards. We see a large influence on norms by codes and influential investor groups.

More international investors, voting advisory associations and shareholder activists want to be involved in dialogue with boards about strategy, succession and income. Indeed, far-sighted boards have 'selected engagements' with stewardship shareholders to create trust.

What more can they do to show all stakeholders that they are improving their enterprises other than through setting a better tone from the top? Should they put big signs on their buildings emphasising integrity, stewardship and respect?

Interest in corporate governance has been increasing since 1992, when shareholder activists forced out the CEO at General Motors and the first corporate governance code – the Cadbury Code – was written. The OECD produced a model code, and many countries produced national versions along the lines of the Cadbury comply or explain model. This has generally led to more transparency, accountability, fairness and responsibility. However, there have been instances where CEOs have gradually amassed too much power, or companies have not developed new strategies and have produced bad results – and sometimes even failure. More are failing since the global financial crisis than previously, hence the increased outside interest in legislation, further supervision and new corporate governance codes for boards, and stewardship codes for shareholders and shareholder activists. The European Commission is developing a regulation for this area as well. Recently, we see that governments want to involve themselves in defending national companies against takeovers by foreign enterprises. We also see a strong movement of green investors, which often is well appreciated by directors. There is a move to corporate citizenship.

This all implies that executive and non-executive directors should work harder and more as a team on long-term policy, strategy, entrepreneurship and investment in R&D. More money is lost through lax or poor directorship than through mistakes. On the other hand, corporate risk management with new risks entering such as a digitalised world and cybercrime is an essential part of directors' responsibilities, as is the tone from the top. How can directors do their important work well without being petrified of attacks from shareholders, regulations and the press?

Each country has its own measures; however, the chapters of this book also show a convergence. Understanding differences leads to harmony. The concept underlying the book is of a one-volume text containing a series of reasonably short, but sufficiently detailed, jurisdictional overviews that permit convenient comparisons, where a quick first look at key issues would be helpful to general counsel and their clients.

My aim as editor has been to achieve a high quality of content so that *The Corporate Governance Review* will be seen as an essential reference work in our field. To meet the all-important content quality objective, it was a condition *sine qua non* to attract as contributors colleagues who are among the recognised leaders in the field of corporate governance law from each jurisdiction.

I thank all the contributors who helped with this project. I hope that this book will give the reader food for thought; you always learn about your own law and best practice by reading about the laws and practices of others. Further editions of this work will obviously benefit from the thoughts and suggestions of our readers. We will be extremely grateful to receive comments and proposals on how we might improve the next edition.

Willem J L Calkoen
NautaDutilh
Rotterdam
March 2019

Chapter 28

UNITED STATES

Adam O Emmerich, William Savitt, Sabastian V Niles and S Iliana Ongun[1]

I OVERVIEW OF GOVERNANCE REGIME

The sources of corporate governance law and regulation in the United States are varied and interrelated. There are four key sources: state corporate law (predominantly Delaware, in which over half of all US publicly traded corporations are incorporated); the federal 1933 Securities Act and 1934 Securities Exchange Act, and the regulations of the Securities and Exchange Commission (SEC) under those Acts; stock exchange listing rules (predominantly the New York Stock Exchange (NYSE) and the NASDAQ); and federal statutes in regard to particular areas of corporate practice (e.g., regulations promulgated by the Federal Reserve and other federal and state agencies with respect to banks and other financial institutions, and by other similar regulatory bodies in respect of communications, transportation and other regulated fields). Because of the federal system of US law, different sources of law are not always harmonised, and corporations are often subject to different obligations to federal and state governments, regulators at each level of government and demands of other relevant bodies, such as the applicable stock exchange. This mosaic of rules and regulations, and the mechanisms by which they are implemented and enforced, make for an environment of frequent change and evolution.

In addition, of increasing importance to the US corporate governance regime are the proxy advisory firms (predominantly Institutional Shareholder Services (ISS) and, with lower market share, Glass, Lewis & Co (Glass Lewis)) and the influence those proxy advisers have on the institutional investor community, and the related prevailing and evolving views of the institutional investor community. That community's views have become particularly influential as the shareholder base of the vast majority of US publicly traded corporations consists of an overwhelming majority of institutional shareholders, including index funds, pension funds and mutual funds. As a result, major institutional investors are increasingly developing their own independent views on preferred governance practices.

Securities laws and regulations are civilly enforced by the SEC, and the SEC must also grant clearance to certain important corporate disclosure documents (such as proxy statements and certain securities registration statements). Larger and older corporations with a history of securities law compliance are subject to fewer such pre-clearance requirements and may in certain cases file abbreviated forms of disclosure. Private investors may also bring

1 Adam O Emmerich, William Savitt and Sabastian V Niles are partners and S Iliana Ongun is an associate at Wachtell, Lipton, Rosen & Katz.

actions under many provisions of the securities laws to recover damages for misstatements or omissions in public statements and in certain other circumstances. The Department of Justice prosecutes criminal violations of federal securities laws and SEC rules.

State law fiduciary duties of directors and officers are predominantly enforced by private actions led by plaintiffs' lawyers. These private actions generally fall into one of two categories: class-action suits on behalf of a particular group of the corporation's shareholders (typically all shareholders who bought or sold during a particular period or all unaffiliated shareholders), and derivative suits purportedly on behalf of the corporation itself. Putative class-action suits must satisfy the criteria under the Federal Rules of Civil Procedure or analogous provisions of state law before being permitted to proceed as a class action, including the numerousness of the class members, the commonality of legal and factual issues among members of the class, the typicality of the claims or defences of the representative parties to the class, and the fairness and adequacy of the representative parties' protection of the class interests. Derivative suits, creatures of state corporate law, provide a mechanism by which shareholder plaintiffs can in theory represent the corporation in suing the corporation's own board of directors or management, sometimes after complying with a 'demand' procedure in which the plaintiff must request that the corporation file suit and be rebuffed. In certain circumstances, especially when it can be shown that the board of directors is for some reason conflicted with respect to the alleged breach of duty, this demand requirement is excused and the shareholder will be permitted to pursue a claim in the corporation's name without further enquiry.

The two primary US stock exchanges, the NYSE and the NASDAQ, each make rules with which corporations must comply as a condition to being listed on these exchanges. These listing rules address all aspects of corporate governance, including topics such as director independence, the composition of various board committees, requirements to submit certain matters to a vote of shareholders, regulation of dual-class stock structures and other special voting rights, publication of and topics covered by corporate governance guidelines, and even requirements related to the corporation's public website. These rules are enforced by the threat of public reprimand from the exchanges, temporary suspension of trading for repeat offences and permanent delisting for perennially or egregiously non-compliant companies.

While proxy advisory firms are not a source of law, their guidelines figure significantly in the corporate governance landscape. ISS has been estimated to control approximately 61 per cent of the proxy advisory market, with Glass Lewis estimated to control approximately 36 per cent. These advisory firms exert pressure on corporations to conform to governance standards they promulgate by issuing director election voting recommendations to each publicly traded corporation's shareholders based on the corporation's compliance with the advisory firm's published standards. Perhaps because of the problem of rational apathy – that is, because an individual shareholder bears all of the costs of becoming an informed voter but shares the benefits with all other shareholders, shareholders have little incentive to inform themselves – proxy advisory firms wield outsized influence on corporate elections, especially among institutional investors such as pension funds.[2] One study found that a recommendation from ISS to withhold a favourable vote in an uncontested director election correlates with a 20.9 per cent decline in favourable voting.[3] In addition, a 2013 study sponsored by Stanford

2 See Michael J Segal, Trevor S Norwitz and Sabastian V Niles, 'SEC Commissioner Critiques Reliance on Proxy Advisory Firms', *Bank and Corporate Governance Law Reporter*, Volume 51, Number 1 (2013).

3 Stephen Choi, Jill Fisch and Marcel Kahan, 'The Power of Proxy Advisors: Myth or Reality?', *Emory Law Journal*, Volume 59 (2010), pp. 869, 886–7.

University found that companies were altering their compensation programmes to comply with proxy advisory firms' ever-evolving policies.[4] The US Congress, the US Department of Labor and the SEC have raised questions regarding fiduciary responsibility in the context of the outsourcing of proxy voting decisions to proxy advisory firms. Significantly, certain major institutional investors, such as BlackRock Inc (which invests over US$6.3 trillion in client assets) and the Vanguard Group (which invests over US$5.1 trillion in client assets) have stated that they reach proxy voting decisions on the basis of their own internally developed guidelines, independent of proxy advisory firms, and have sought to engage directly and pragmatically with companies. These major institutions are uniquely positioned to use their influence to recalibrate the system to reduce reliance on proxy advisory firms.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), signed into law in July 2010, was passed in response to corporate governance practices perceived by some to have contributed to the 2008–2010 economic crisis. The Dodd-Frank Act requires additional disclosure in corporate proxies and non-binding shareholder votes on various questions of corporate governance (notably, related to executive compensation), and contemplates greater access for shareholder-proposed director nominees to the company proxy. More recently, in response to increasing company compliance costs, in 2018 the SEC adopted rule amendments to streamline disclosure requirements and reduce duplicative or overlapping disclosure obligations.

II CORPORATE LEADERSHIP

Under Delaware law, 'The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors'.[5] The corporation law of all other US states similarly assigns corporate managerial power to the board of directors.

i Board structure and practices

Boards of directors customarily organise committees to carry out specific functions without the presence of the entire board. State law generally permits most of the functions of the board of directors to be delegated to committees,[6] and generally permits directors to rely on information, opinions, reports or statements presented to the board by its committees.[7] Boards are specifically required by federal securities law to have an audit committee with certain prescribed functions relating to the retention, compensation and oversight of the company's independent auditor. Federal securities law and NYSE and NASDAQ listing rules also require listed companies to maintain compensation and nominating or corporate governance committees. Boards will often voluntarily establish additional committees: for example, a company in the technology sector might establish a technology committee comprising directors with the most applicable expertise to stay abreast of technological developments, and a company that has important relationships with labour unions might choose to establish a labour relations committee. By custom, many companies have established a risk committee

4 David F Larcker, Allan L McCall and Gaizka Ormazabal, 'Outsourcing Shareholder Voting to Proxy Advisory Firms', Rock Center for Corporate Governance at Stanford University Working Paper No. 119 (2013).

5 Delaware General Corporation Law, Section 141(a).

6 See, e.g., Delaware General Corporation Law, Section 141(c)(2).

7 See, e.g., Delaware General Corporation Law, Section 141(e).

(actually required of certain financial institutions by the Dodd-Frank Act), an executive committee, a finance committee, a public policy committee, or some subset thereof. Boards may also establish *ad hoc* committees in response to discrete or emergent developments.

A panoply of regulations and disclosure requirements affect the composition of boards of directors. Federal securities laws require all directors who serve on audit, compensation and nominating committees to be independent from the management of the company, and NYSE and NASDAQ listing rules require a majority of the board of directors to be independent. In addition, in 2018 California passed a law mandating female representation on the boards of publicly held companies based in the state. Companies are required by federal securities laws to disclose the experience, qualifications or skills of each director nominee that led the board to nominate that person to serve as a director. A company must also disclose whether and how its nominating committee considers diversity in identifying director nominees, and must make extensive disclosure about the nominating committee and how it functions.

Just under half of large corporations in the United States have a common CEO and chair of the board of directors. Companies that have one person serving as both chair and CEO typically have a lead director with additional rights, responsibilities and compensation. In 2018, about 52 per cent of companies listed on the S&P 500 Index had separate chairs and CEOs, up from 29 per cent in 2005. ISS generally recommends a vote in favour of shareholder proposals requiring an independent chair, taking into consideration the company's current board leadership structure (including whether the company maintains a strong lead director position), governance structure and practices (including overall board independence) and the company's performance. In 2018, shareholders brought proposals at 48 companies to require an independent chair. These proposals enjoyed an average level of support of 32 per cent. Companies are also required to describe in their annual meeting proxy statements the leadership structure of their board of directors, such as whether the same person serves as chair and CEO, and to explain why the company has determined that its leadership structure is appropriate. To date, the governance trend is towards ensuring an independent board leadership structure through a lead independent director, as opposed to separating the CEO and chair functions in all companies.

Corporations are generally permitted by state corporate law to have classified, or staggered, boards of directors, in which roughly one-third of the directors are elected each year for three-year terms; however, classified boards have become substantially less common in recent years. With a classified board, shareholders can replace a majority of the directors only in two election cycles, so a classified board can promote the continuity and stability of a corporation's long-term strategy, reduce a corporation's vulnerability to abusive takeover tactics, and ensure that the institutional experience of the board of directors will not be swept away in a single lopsided election. On the other hand, classified boards historically have not halted well-priced, all-cash takeover bids. The percentage of S&P 500 companies with staggered boards has declined, to approximately 11 per cent in 2018, down from approximately 57 per cent in 2003. Shareholder proposals to declassify boards of directors enjoy strong support from shareholders: shareholders voted on such proposals at seven companies in 2018, and the proposals averaged approximately 86 per cent shareholder support. (Shareholders voted on 46 management-initiated proposals to declassify boards in 2018, and these averaged 99 per cent shareholder support.) However, corporations are more likely to implement a classified board in connection with an initial public offering (IPO). Despite an ISS policy of recommending a withhold vote for directors at the first public company annual meeting of a corporation that implements a classified board in connection with an IPO, in recent years more than half of

IPO corporations implemented a classified board in connection with the offering,[8] although some companies provide that the classified board will be declassified within several years of the IPO. Notwithstanding the trend towards removing classified boards, a 2013 empirical study confirmed that classified boards can enhance shareholder value.[9]

Delaware law currently permits corporations to choose whether and how to afford insurgent director nominees access to a company's proxy statement, but rules implemented by the SEC enhance the ability of shareholders to propose providing groups of shareholders without control intent to nominate up to a certain portion (typically 25 per cent) of the company's entire board, known as proxy access. The interest in proxy access as a democratisation of corporate governance and voting has garnered increased strength. In late 2014, a group of pension funds announced a broad campaign to install proxy access at over 75 US publicly traded companies of diverse market capitalisations and across a variety of industry sectors. In 2018, shareholders at 41 companies voted on shareholder-initiated proposals to grant shareholders proxy access, and the proposals averaged 32 per cent support. These shareholder proxy access proposals typically seek to permit shareholders to nominate between 20 and 25 per cent of a company's entire board. Many companies are also either proactively revising by-laws to permit proxy access or submitting management-initiated proxy access proposals for shareholder consideration. Although shareholder proxy access is becoming more prevalent, it remains to be seen to what extent shareholders will seek to exercise proxy access rights.

Historically, brokers holding stock of a corporation on behalf of clients have voted that stock at their discretion when their clients do not provide specific voting instructions. However, the NYSE listing rules now prohibit broker discretionary voting for listed companies on certain topics including governance-related proposals, and the Dodd-Frank Act eliminated broker discretionary voting in elections related to the election of directors, executive compensation and any other significant matter as determined by the SEC. As a result, directors in uncontested elections have more difficulty achieving majority votes. Lack of broker discretionary voting also increases the influence of activist shareholders and the power of proxy advisory firms such as ISS. Further concentrating voting power in the hands of activists is the problem of empty voting, in which an activist uses derivatives and similar arrangements to purchase voting power without taking on commensurate economic exposure to the corporation's stock – for example, by simultaneously purchasing and short-selling a stock, resulting in no net economic exposure or investment costs aside from transaction fees.

In uncontested elections, directors were historically selected by plurality vote, but in recent years, majority voting policies have been adopted by approximately 90 per cent of companies included in the S&P 500 Index. Under a majority voting policy, directors in uncontested elections must receive a majority of the votes cast, rather than the plurality required by Delaware law, and if they do not must tender their resignation, although Delaware courts will generally defer to a board's business judgement on whether to accept or reject a resignation from a director in such circumstances. Because directors must win a plurality of votes regardless of a corporation's majority voting policies, these policies have

8 Cheap, James, 'Board Classification and Diversity in Recent IPOs,' The Harvard Law School Forum on Corporate Governance and Financial Regulation (24 April 2018), available at https://corpgov.law.harvard.edu/2018/04/24/board-classification-and-diversity-in-recent-ipos.

9 Seoungpil Ahn and Keshab Shrestha, 'The Differential Effects of Classified Boards on Firm Value', *Journal of Banking and Finance*, Volume 37, Issue 11 (2013).

relatively less effect in the context of contested elections; their primary effect is to increase the power of withhold recommendations from ISS against incumbent directors running in uncontested elections.

ii Directors

Directors' most basic and important responsibility is to exercise their business judgement in a manner they reasonably believe to be in the best interest of a corporation and its shareholders. In Delaware and 32 other states and the District of Columbia, where legislation approving a new corporate form – the benefit corporation – has been passed, directors of such corporations have an expanded fiduciary obligation to consider other stakeholders in addition to shareholders, including their overall impact on society, their workers, the communities in which they operate and the environment.

In most situations, directors do not and should not manage the day-to-day operations of the corporation, but instead exercise oversight in reasonable reliance on the advice of management, outside consultants hired by the corporation and their own understanding of the corporation's business. The courts will generally defer to decisions that boards make, granting them the 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company' – a presumption referred to as the business judgement rule.[10] The business judgement rule applies to most decisions that a board of directors makes. When a shareholder challenges a board's business judgement, 'the court merely looks to see whether the business decision made was rational in the sense of being one logical approach to advancing the corporation's objectives'.[11] To obtain the protection of the business judgement rule, directors must satisfy their duty of care, which entails reviewing the available material facts, and their duty of loyalty, which requires the disinterest and independence of the directors. In practice, the business judgement rule will protect directors when the corporate records reflect that they reviewed and considered the facts available to them and the advice of their advisers and when the directors did not have a conflict of interest in the decision.

The board of directors should work with management to set an appropriate 'tone at the top' of the corporation to encourage conscientiousness, transparency, ethical behaviour and cooperation throughout the organisation. It should approve the company's annual operating plan and guide its long-term strategy, and should monitor and periodically assess the corporation's performance in terms of these goals. The board should monitor and evaluate its own performance as well, noting any deficiencies in its expertise and composition with an eye towards rectifying them with future director nominations. It should monitor the organisation's risk management practices, as well as compliance with applicable law and best practices, set standards for corporate social responsibility, and oversee relations with regulators and the corporation's various constituencies, which increasingly includes engaging directly in director-level dialogue with shareholders. It should evaluate the corporation's CEO and senior management, and ensure that a succession plan is in place for the CEO and senior management, an issue that has received heightened focus in light of increased turnover rates and visible succession crises. When a company receives a proposal for a large transaction that creates a conflict – or the appearance of a conflict – between the interests of the corporation's

10 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

11 *In re Dollar Thrifty S'holder Litigation* (Del. Ch. 8 September 2010).

shareholders and its management, the board should take care to place itself at the centre of the transaction, and should consider the merits of a special committee of independent directors to oversee the company's response to the proposal.

Directors enjoy substantial protection against personal liability for failures of board oversight. Under Delaware law, directors can be held personally liable for a failure to monitor only where there is 'sustained or systemic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists', which is a 'demanding test'.[12] Delaware courts have repeatedly emphasised that they will not impose liability under this standard unless directors have intentionally failed to implement any reporting system or controls or, having implemented such a system, intentionally refused to monitor the system or ignored any red flags that it raised. Proxy advisory firms and institutional investors have also been increasingly willing to wield the threat of withhold vote recommendations in response to perceived risk oversight failures or missteps.

III DISCLOSURE

Public corporations are subject to a disclosure regime that generally requires annual and quarterly reports, as well as current reports, to be filed following the occurrence of certain events, such as entry into material agreements, completion of significant acquisitions or dispositions of assets, and changes in officers or directors and amendments to the corporation's charter or by-laws. Public disclosure is also required of certain transactions in the corporation's securities by corporate insiders, such as officers and directors, and of material non-public information that a corporate insider has disclosed to certain individuals, such as stock analysts or shareholders. Additionally, the corporation must make significant disclosure whenever it solicits proxies for the votes of shareholders, as it must in connection with the election of directors or significant transactions, such as mergers or the sale of substantially all corporate assets.

Securities regulations require substantial annual disclosure of compensation awarded to the five named executive officers (NEOs) of a corporation, which are the CEO, CFO and the three other most highly compensated executive officers. The disclosure must describe all material elements of the NEOs' compensation, including the overall objectives of the compensation programmes, the process for determining the amount of each element of compensation and the rationale underlying that process. Federal securities laws also require disclosure regarding the relationship between executive compensation and the company's financial performance, the company's policies governing hedging transactions of the company's stock by employees and directors, and the ratio of the total compensation of the CEO to the median compensation of the company's employees. In furtherance of the Dodd-Frank Act requirements, in 2015 the SEC adopted a rule requiring companies to disclose in registration statements, proxy statements and annual reports the ratio of CEO compensation to the median compensation of the company's employees. The methodology for identifying the median employee compensation is not set forth in the rule, but is instead determined by each company.

12 *In re Caremark International Inc Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996).

IV CORPORATE RESPONSIBILITY

The board of directors should ensure that the corporation has a healthy and balanced attitude towards risk – keeping in mind that there is danger in excessive risk aversion, just as there is danger in excessive risk taking – and it should set standards for corporate risk management. When the corporation's risk management functions raise a red flag, the board of directors should investigate the occurrence and see that the corporation takes measures appropriate to remedy any problems that it uncovers. The board should periodically review the effectiveness of the corporation's risk management reporting functions (including how risks are identified and reported upward, how management responsibility for risk management is allocated and whether risk managers have access to the board of directors and senior management) and repair any deficiencies that it uncovers. In the United States, recent cybersecurity-related intrusions have brought heightened attention and scrutiny to questions of risk oversight and effective risk mitigation practices.

Some corporations have a dedicated board-level risk management committee, which the Dodd-Frank Act requires of certain publicly traded bank holding companies and non-bank financial holding companies, but most boards situate the risk management function at the audit committee, in response to a listing rule of the NYSE that requires the audit committee to discuss risk assessment and risk management policies. Companies are required to disclose in their annual proxy statement the extent of the board's role in risk oversight activities and how the board administers its oversight function. The SEC has also issued specific guidance addressing when and how cybersecurity risks should be publicly disclosed. The reputational damage to boards and companies that fail to properly manage risk is a major threat, and ISS now includes specific reference to risk oversight as part of its criteria for choosing when to recommend withholding votes in uncontested director elections.

V SHAREHOLDERS

i Shareholder rights and powers

Shareholders are permitted to vote at annual and special meetings. State corporation law typically entitles shareholders to vote on matters including elections of directors, amendments to the corporation's charter, transactions in which the corporation is acquired and sales of substantially all of the corporation's assets. The NYSE requires a shareholder vote prior to the issuance of stock that will exceed 20 per cent of the voting power or common stock outstanding after the issuance. In addition, Rule 14a-8 under the federal Securities Exchange Act permits shareholders to propose and vote on additional non-binding resolutions, which typically concern issues of social justice or corporate responsibility. In 2018, shareholders voted on 171 proposals concerning social and environmental issues (with 29 proposals focused specifically on climate change and 49 focused on lobbying and political spending). Environmental and social issues are becoming increasingly important to shareholders, with large institutional investors announcing a heightened focus on socially responsible investing and certain activist investors launching new funds with the same focus.

Corporations must also conduct a non-binding shareholder vote at least every three years to approve the compensation of their NEOs – votes that ISS policy also encourages – and an additional non-binding shareholder vote at least every six years to determine the frequency of these 'say on pay' votes.[13] Non-binding advisory votes are also now required with respect to golden parachute compensation arrangements triggered by a merger or acquisition transaction. However, the Jumpstart Our Business Startups Act, or JOBS Act, signed into law in January 2012, exempts newly public 'emerging growth companies' from say on pay votes and certain other requirements for the earlier of five years or until the company meets specified size thresholds.

ii Shareholders' duties and responsibilities

Under Regulation 13D of the Securities Exchange Act, shareholders or groups of shareholders acting in concert who acquire over 5 per cent of a company's stock must publicly disclose their ownership stake within the next 10 days. Schedule 13D requires disclosure of the shareholder's or group's investment purposes, including any plans or proposals relating to significant transactions involving the company. The disclosure statement must also be amended promptly to reflect any material changes to information previously disclosed. Passive investors acquiring over 5 per cent of a company's stock who certify that the securities were not acquired, and are not held, with the purpose or effect of changing or influencing control of the issuer may instead disclose ownership on a short-form Schedule 13G, the disclosure requirements of which are less onerous than those of the long-form Schedule 13D.

iii Shareholder activism

Hostile takeovers and shareholder activism – the capture of corporate control or influence over corporate policy by discrete groups of shareholders, typically to subjugate a corporation's long-term strategy in pursuit of short-term profits or the return of capital to shareholders – are a significant threat to US corporations.[14] In addition to cultivating strong relationships with its long-term institutional shareholder base, dealing with unsolicited offers and pressure from shareholder activists is more art than science.[15]

iv Takeover defences

A critically important tool for enabling boards of directors to discharge their fiduciary duties in the face of the threat of hostile takeovers and shareholder activism under current law remains the shareholder rights plan, or 'poison pill'.

The shareholder rights plan entails a dividend of special rights to each of the corporation's shareholders. In the event that a shareholder amasses equity ownership in excess of a predetermined threshold – often 10 to 15 per cent (with perhaps a higher threshold used for passive institutional investors) – without the approval of the board of directors, the rights held by every other shareholder trigger and convert into the right to purchase stock of

13 For a discussion of effective shareholder engagement in the context of compensation policies, see Adam J Shapiro et al., 'Compensation Season 2019,' The Harvard Law School Forum on Corporate Governance and Financial Regulation (11 January 2019), https://corpgov.law.harvard.edu/2019/01/11/compensation-season-2019/.

14 See Martin Lipton et al., 'Activism: The State of Play at Year-End 2018,' The Harvard Law School Forum on Corporate Governance and Financial Regulation (2 January 2019), https://corpgov.law.harvard.edu/2019/01/02/activism-the-state-of-play-at-year-end-2018.

15 See Martin Lipton et al., 'Dealing with Activist Hedge Funds and Other Activist Investors,' The Harvard Law School Forum on Corporate Governance and Financial Regulation (25 January 2019), https://corpgov.law.harvard.edu/2019/01/25/dealing-with-activist-hedge-funds-and-other-activist-investors-2.

the corporation at a price substantially below the current market value. Alternatively, most rights plans provide that the board of directors may instead choose to exchange one share of common stock for each right held by shareholders other than the hostile bidder or activist shareholder. Either way, the result of this conversion or exchange is that the ownership position of the triggering shareholder is substantially diluted.

The rights plan is the only structural takeover defence that allows a board to resist a hostile takeover attempt, and it has also been deployed in numerous activism situations. While it does not provide complete immunity from a takeover, it allows the board to control the process and provides the corporation with leverage to bargain for a higher acquisition price and the power to reject underpriced or otherwise inappropriate bids. It is also implemented exclusively by the board of directors and does not require shareholder approval, so it can be put in place in very short order.

The principal disadvantage of the rights plan is that ISS will typically recommend a withhold vote for all directors after the adoption of a rights plan that the company does not subject to shareholder ratification within a year of adoption. As a result, and because a rights plan can be adopted quickly, most corporations adopt a rights plan only after a takeover threat appears – and prior to that time, the plan is 'kept on the shelf'.

Keeping a rights plan on the shelf offers almost all of the protection of an active rights plan without any risk from an adverse ISS recommendation, but it can leave a corporation vulnerable to stealth acquisitions, in which an activist shareholder purchases just under 5 per cent of a company's stock, and then buys as much as possible on the open market within the next 10 days. Because Regulation 13D under the Securities Exchange Act gives shareholders 10 days after acquiring over 5 per cent of a company's stock to publicly disclose their ownership stake, this technique can result in an acquisition of a substantial portion of a company's equity before it is ever disclosed.[16] Similarly, Regulation 13D patrols a narrow beat with regard to derivatives. While all interests must be disclosed after a shareholder crosses the 5 per cent threshold, only some derivative interests are counted towards that threshold – generally, only those that are settled in kind (for stock of the corporation rather than for cash from the derivatives counterparty), and only those that can be exercised within the next 60 days.[17] However, because an activist may accumulate its position in a corporation, without public disclosure, the board of directors may not have any warning of the activist's behaviour, and there is thus some risk that a company may not be able to adopt a rights plan in time to avoid a significant accumulation of stock in unfriendly and opportunistic hands.

16 See Adam O Emmerich, Theodore N Mirvis, Eric S Robinson and William Savitt, 'Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power', *Harvard Business Law Review*, Volume 3 (2013), for a discussion of the shortcomings of Regulation 13D.

17 Regulation 13D discourages shareholders from employing contracts or arrangements that divest beneficial ownership of a security as part of a plan or scheme to evade the reporting requirements of Section 13(d) of the Securities Exchange Act by counting the securities towards the 5 per cent threshold (Securities Exchange Act Rule 13d-3(b)). One court applied this provision to impute beneficial ownership to a shareholder of securities in which the shareholder had acquired derivative interests: *CSX Corp v. Children's Inv Fund Management*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008). Still, no bright-line rule has emerged to determine when a shareholder's use of derivative instruments is suspicious enough to constitute such a plan or scheme to evade the reporting requirements, so the case offers only marginal protection from raiders and activist shareholders.

Other defences against activist shareholders include a classified board of directors, limiting shareholders' ability to call a special meeting, adopting an advance notice by-law that requires rigorous disclosure of a shareholder's holdings and other interests in a corporation to nominate a director candidate or propose other items of business at a special or annual meeting, and limiting shareholders' ability to act by written consent (70 per cent of S&P 500 companies prohibit shareholder action by written consent).

Overall, the availability of takeover defences has been steadily eroded over the years, predominantly as a result of shareholder activism led by ISS, union and public pension funds and academics. Today, only 1 per cent of S&P 500 companies have a rights plan in effect, down from 45 per cent in 2005 and 60 per cent in 2000. In 2018, shareholders at 67 companies voted on proposals to grant shareholders the right to call special meetings or to decrease the requirements to call a special meeting, with an average level of support of 41 per cent, and shareholders at 40 companies voted on proposals to grant shareholders the right to act by written consent or to decrease the requirements to act by written consent, with an average level of support of 43 per cent.

v Contact with shareholders

Shareholder relations have become increasingly complicated as a result of activist trends and have required greater attention at the board level, prompting a renewed focus on the proper role of direct dialogue between boards and shareholders, as well as the benefits and disadvantages of more open, regular lines of communication. Shareholder engagement is increasing, as both companies and institutional investors have sought to engage in more regular dialogue on corporate governance matters. A report by the EY Center for Board Matters at Ernst & Young LLP suggests that approximately 77 per cent of S&P 500 companies included disclosures about their shareholder engagement efforts in their 2018 proxy statements, compared with approximately 56 per cent in 2015.[18] Recent disclosure reform efforts have also sought to require institutional shareholders to report their share positions on a more current basis as of the end of each quarter than is now the case, as well as suggesting more frequent reporting. Management generally serves as the primary caretaker of shareholder relationships, with the board providing oversight as to the presence of an effective shareholder relations programme. However, institutional investors are increasingly voicing their expectation that companies should provide access to independent directors. Some activists have also been seeking direct dialogue generally with companies in which they invest, independent of whether operational or other performance issues exist. In 2016, a group of large public companies and investors jointly developed and endorsed a set of principles on corporate governance that, among other things, called for active engagement with shareholders on key issues. Similarly, in 2018, BlackRock called for a new model of shareholder engagement based on year-round discussions among management, the board and shareholders about long-term value creation and long-term corporate contribution to society at large. Where shareholders request direct communications with the board, it may be desirable for directors, in appropriate circumstances and following consultation with management, to accommodate those requests. The policies and arrangements best suited for any given company will depend on, among other things, the preferences of directors, the

18 EY Center for Board Matters, '2018 Proxy Season Review' (2018).

nature and extent of existing relationships with major shareholders, the expressed preferences of those shareholders, and the structure and staffing of the company's existing shareholder relations programme.

In 2000, the SEC promulgated Regulation FD to prevent companies from selectively disclosing material and non-public information to large investors and analysts. Under Regulation FD, certain employees of a company – including directors, officers, public relations or investor relations professionals, and others with similar responsibilities or who regularly communicate with market professionals or shareholders – may intentionally disclose material non-public information about a company only if the material is simultaneously disclosed to the public. If they disclose the information unintentionally, the same information must promptly be disclosed publicly. Disclosures made to the press and disclosures made in the ordinary course of business (e.g., customary communications with distributors or customers) are exempted. Intentional disclosures include disclosures in which the employee was reckless in not knowing that the information is material and non-public.

Information is considered material if there is a substantial likelihood that a reasonable investor would consider the information important when making investment decisions, and if the information adds significantly to the total mix of information available. Even if information is quantitatively insignificant, it may still be considered qualitatively material, and information is more likely to be deemed material in hindsight in light of subsequent reaction by the market. The SEC has issued guidance that certain categories of information are particularly likely to be considered material – among them, information related to earnings; corporate events such as mergers, bankruptcy, tender offers or changes in control; and products, discoveries and developments with respect to material contracts, customers or suppliers. And while purported clarifications to previously announced information can themselves be considered material and non-public, 'Regulation FD does not require that corporate officials only utter verbatim statements that were previously publicly made'.[19]

Regulation FD makes unscripted dialogues between company officials and individual analysts and shareholders risky.[20] While it is unusual for companies to prohibit such meetings altogether, they should be approached carefully and by professional spokespeople only. Boards of directors should adopt corporate governance guidelines that ensure that the company's media strategy is executed only through approved channels, and with the understanding that analysts and shareholders will often engage in such private dialogues with the hope of ferreting out exactly the sort of information that Regulation FD forbids company officials from disclosing in such a forum.

VI OUTLOOK

Corporate governance in the United States has changed dramatically over the past 30 years, and will undoubtedly continue to evolve in significant ways in the coming years. In particular, the SEC has increased its focus on 'proxy plumbing', including with respect to the accuracy, transparency and efficiency of the voting process; shareholder communications and retail participation in the voting process; and misalignment of voting power and economic interests (including through empty voting strategies involving purchasing voting securities

19 *SEC v. Siebel Systems, Inc*, 384 F. Supp. 2d 694, 704-05 (S.D.N.Y. 2005).

20 See David A Katz, David B Anders and Sabastian V Niles, 'Regulation FD Compliance Requires Continued Vigilance', Securities Reform Act Litigation Reporter, Volume 36, Number 1 (2013).

and then hedging away the economic exposure with derivatives). The SEC has indicated that it is continuing to review the role of proxy advisory firms such as ISS and Glass Lewis in the voting process, which, in light of ISS's substantial influence in the evolution of corporate governance norms over the past several decades, may have long-term and far-reaching implications. The SEC has also received many proposals for the reform of the Regulation 13D reporting regime, including to encompass additional forms of economic interests and to close the 10-day reporting window that raiders have used in recent years to facilitate stealth acquisitions of control blocks without paying a premium. Similarly, in 2016, legislation was introduced in the Senate seeking amendments to Regulation 13D that would require greater transparency from investors accumulating large positions in public securities.

At the state level, the courts of Delaware have been refining the fiduciary duty rules applicable to conflict transactions and the review of merger and acquisition proposals in recent years, often to increase the scrutiny directors will face in connection with such transactions and, more generally, to recalibrate the relative power of shareholders and directors. Spurred on by the accounting scandals of the early 2000s and the financial crisis at the end of the past decade, the political and public appetite for ever more corporate governance remains strong. However, we have recently seen a heightened awareness of short-termist pressures in the markets and their impact on boards of directors charged with guiding a company's strategy to achieve long-term value creation, including an increased focus on the extent to which new corporate governance reforms may exacerbate, rather than ameliorate, short-termist pressures. Shareholder engagement practices have significantly evolved as well, with the frequency and depth of engagement increasing alongside a more fundamental rethinking of the nature of relationships with shareholders and the role that these relationships play in supporting – or undermining – board efforts to take long-term perspectives. A central aspect of the continuing debate is whether initiatives styled as governance reforms operate to shift the locus of control over the corporate enterprise from those with direct knowledge, involvement in and fiduciary responsibilities for the enterprise towards entities lacking those attributes, and whether imposing some form of duties, regulations or mandated best practices on such entities is needed.

In many respects, the relentless drive to adopt corporate governance mandates seems to have reached a plateau in the United States, with essentially all of the prescribed best practices – including say on pay, the dismantling of takeover defences, majority voting in the election of directors and the declassification of board structures – having been codified in rules and regulations or voluntarily adopted by a majority of S&P 500 companies. Whether this portends a new era of more nuanced corporate governance debates, where the focus has shifted from 'check the box' policies to more complex questions such as striking the right balance in recruiting directors with complementary skill sets and diverse perspectives, and tailoring the board's role in overseeing risk management to the specific needs of the company, remains to be seen.

Continued debate over, and the evolution of, US governance rules thus appear likely.

Appendix 1

ABOUT THE AUTHORS

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Adam O Emmerich focuses primarily on mergers and acquisitions, securities law matters and corporate governance. His practice has included a broad and varied representation of public and private corporations and other entities in a variety of industries throughout the United States and abroad in connection with M&A, divestitures, spin-offs, joint ventures and financing transactions. He also has extensive experience in takeover defence. Mr Emmerich is recognised as one of 500 leading lawyers in America by *Lawdragon*; as one of the world's leading lawyers in the field of mergers and acquisitions in the *Chambers Global* guide to the world's leading lawyers; as an expert in each of M&A, corporate governance and M&A in the real estate field by *Who's Who Legal*; and as one of the world's leading lawyers both in M&A and in corporate governance by *Euromoney Institutional Investor*.

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