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DOCUMENT INDEX **TAB**

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Mergers and Acquisitions—2023

2022 was a tale of two halves for M&A. The beginning of the year was active, as robust dealmaking carried over from the record-breaking levels of 2021 to drive approximately $2.2 trillion worth of global deals through the first half of the year, compared to approximately $2.7 trillion worth of such deals announced over the same time period in the previous year. M&A activity slowed considerably after the first half of 2022, however, as significant dislocation in financing markets, an increasingly volatile stock market, declining share prices, concerns over inflation, rapidly increasing interest rates, war in Europe, supply chain disruption and the possibility of a global recession undermined business and consumer confidence and created hesitancy to agree to major transactions. The year ended with total deal volume of $3.6 trillion globally, down from $5.7 trillion in 2021 but in line with the $3.5 trillion of volume in 2020 as well as with the five-year average (excluding 2021), and in a sense was the inverse of 2020, which saw a precipitous decline in M&A activity in the first half at the outset of the Covid-19 pandemic, followed by a surge in the second half driven by massive liquidity and low interest rates. Transactions involving U.S. targets and acquirors continued to represent a substantial percentage of overall deal volume, with U.S. M&A totaling over $1.5 trillion (approximately 43% of global M&A volume) for the year, as compared to approximately $2.5 trillion (roughly 43% of global M&A volume) in 2021.

Notwithstanding lower overall activity, 2022 witnessed a number of megadeal announcements, including Elon Musk's $44 billion acquisition of Twitter, Broadcom's $61 billion acquisition of VMware, Adobe's $20 billion purchase of Figma, Prologis's $26 billion acquisition of Duke Realty, Microsoft's $68.7 billion acquisition of Activision Blizzard and Kroger's $24.6 billion purchase of Albertsons. The overall number of megadeals decreased, however, with only six $25 billion-plus deals and thirty $10 billion-plus deals announced in 2022, compared to 10 and 53, respectively, during 2021, likely reflecting greater reluctance to pursue large transactions in the current regulatory environment as well as valuation gaps between buyers and sellers and more challenging financing markets than in the previous year. A wide number of companies also announced separations, divestitures, carve-outs and spin-offs across industries over the course of the year, with over thirty $1 billion-plus divestitures and nearly forty spin-offs announced. In addition, both during the first half of 2022 and even during the second half of the year, companies faced unsolicited overtures and takeover bids, public and private, requiring advance preparation and tailored strategies in order to handle such acquisition interest effectively.

As we kick off the new year, we review below some of the key themes that drove M&A activity in 2022 and discuss expectations for 2023.

Technology Transactions

Following a pandemic-driven boom that accelerated years-long trends, the technology industry faced significant headwinds in 2022 as remote work, online shopping and other changes driven in part by the Covid-19 pandemic began to ease or reverse and ongoing interest rate hikes

sapped the attractiveness of future growth relative to present earnings. Most notably, the IPO market for tech companies (and generally) ground to an almost complete halt, with the number of tech companies raising at least $1 billion in their IPOs falling from twelve in 2021 to zero in 2022 and major anticipated IPOs, such as those of Instacart and WeTransfer, shelved for the foreseeable future.

Consistent with trends in recent years, technology transactions continued to play a significant role in the M&A story in 2022, with tech deals responsible for approximately 20% and 32% of overall global deal volume and U.S. deal volume, respectively, and with four of the six transactions over $20 billion announced in 2022 being in technology-related sectors. In addition to Elon Musk's acquisition of Twitter, one of the most prominent M&A sagas in recent memory, significant tech transactions included large public company transactions, such as Microsoft's $68.7 billion acquisition of Activision Blizzard, Broadcom's $61 billion acquisition of VMware and Adobe's $20 billion acquisition of Figma, as well as a number of large private equity-backed deals, including the $16.5 billion acquisition of Citrix Systems by affiliates of Vista Equity Partners and Evergreen Coast Capital, Zendesk's $10.2 billion acquisition by a consortium led by Permira and Hellman & Friedman and Thoma Bravo's $10.7 billion acquisition of Anaplan and $8 billion acquisition of Coupa Software.

Technology M&A was not immune from the broader downturn in the technology space, however, and global tech M&A volume declined by approximately 36% year-over-year (from over $1.1 trillion in 2021 to approximately $720 billion in 2022), as dramatically reduced public and private tech valuations, diminished growth prospects, belt tightening in anticipation of a possible recession (including a number of layoff announcements in the tech sector) and intense regulatory and media focus dampened boardroom enthusiasm and contributed to reluctance to engage in acquisitions.

As volatility in valuations eventually declines, interest rates eventually settle and post-pandemic winners and losers become clearer, we expect that tech will continue to be an active area of M&A in 2023. Strategic acquirors that have thoughtfully managed their balance sheets and private equity funds that have ample dry powder may be eager to pursue tech (and other) targets that would have previously been out of reach at the much higher valuations many companies enjoyed in 2021. Further, the trends that support dealmaking—a desire to expand and diversify product offerings, drive growth, enhance efficiency, remain competitive and respond to innovation—remain just as present as ever. Technology will continue to revolutionize the market for products and threaten existing business models, which may create opportunities for M&A and other corporate transactions. For example, in early 2023, Microsoft announced a multi-year, multi-billion dollar investment (reported to total $10 billion) in OpenAI, the developer of pathbreaking artificial intelligence bot ChatGPT. The deal announcement included Microsoft's agreement to deploy OpenAI's models across its consumer and enterprise products and to introduce new categories of digital experiences built on OpenAI's technology. The Microsoft/OpenAI transaction illustrates the potential need for well-established tech leaders to look to bolt-on M&A as a source of product innovation and expansion.

At the same time, the environment for tech companies has only grown more complex, particularly with heightened regulatory, political and public scrutiny (evidenced by, for example,

the FTC's announcement that it would be seeking to block Microsoft's acquisition of Activision Blizzard, the introduction of bipartisan legislation in the U.S. Senate and U.S. House of Representatives to ban Chinese-owned social media app TikTok from operating in the United States and widespread attention focused on the crypto industry following the November 2022 implosion of cryptocurrency exchange FTX). All of these developments contribute to a more challenging environment for tech transactions and underscore the importance of early and proactive planning, thorough diligence and collaboration with experienced advisors to identify creative legal and structural opportunities that will maximize the likelihood of successful outcomes.

Healthcare M&A

Although the pace of healthcare M&A was down in 2022, a steady stream of healthcare deals were signed over the course of the year as large pharmaceutical, health insurance and other industry participants turned to acquisitions to drive growth. As overall M&A slowed considerably in the latter half of the year in particular, healthcare remained a bright spot, with the announcements of two transactions over $15 billion (Johnson & Johnson's $16.6 billion acquisition of Abiomed and Amgen's $27.8 billion acquisition of Horizon Therapeutics) and an additional six deals over $3 billion. Pfizer was a major contributor to the level of healthcare M&A, announcing a number of deals, including its $11.6 acquisition of Biohaven Pharmaceuticals, $5.4 billion acquisition of Global Blood Therapeutics and $525 million acquisition of ReViral. Healthcare also overtook technology as the top industry for de-SPAC transactions in 2022, with healthcare targets constituting 24% of de-SPAC targets, while technology companies constituted 21% of de-SPAC targets.

Trends expected to support healthcare M&A in 2023 include (1) the looming patent cliff (in which approximately $230 billion worth of pharmaceutical revenue will lose patent protection before the end of the decade), (2) pharmaceutical and medical device companies with healthy balance sheets and capacity to take on new debt and (3) the continual drive to innovate, evidenced, for example, by forays by retailers and tech companies into the healthcare sector (including CVS Health's $8 billion purchase of Signify Health and Amazon's $3.9 billion acquisition of One Medical). At the same time, indications that regulators are focusing on the effects of healthcare deals, including a June 2022 workshop hosted by the FTC and the DOJ to explore new approaches to regulating pharmaceutical M&A, will put a premium on thoughtful transaction planning in this space.

Financial Institutions M&A

Financial institutions M&A slowed significantly in 2022 relative to the pace of activity in 2021, returning to average levels over the preceding decade. Toronto Dominion's $13.4 billion acquisition of First Horizon, announced in February 2022, was the banking sector's largest transaction by a wide margin and only a small number of other transactions exceeded $1 billion in deal value. Recessionary fears, lower stock valuations and concerns about a highly politicized regulatory environment combined to tamp down merger activity in the sector. This provided a sharp contrast to 2021, when a number of large bank deals were announced, including the Bank of Montreal's $16.3 billion acquisition of Bank of the West and U.S. Bancorp's $8 billion

acquisition of MUFG Union Bank. A particularly notable 2022 transaction was TIAA's announcement that it would sell TIAA Bank to an investor group including private equity sponsors with deep experience investing in regulated financial institutions. A steady stream of sub-$500 million deals contributed to the number of deals that were announced in 2022, also declining meaningfully year-over-year but still matching historical averages.

While Fintech activity demonstrated some resilience, it too retreated in the second half of the year, reflecting the realignment of valuations after several years of rapid growth. M&A slowed, venture funding volumes declined and few IPOs were completed. Intercontinental Exchange Inc.'s $13 billion acquisition of Black Knight, Inc. led the field in transaction size. In parallel, digital assets and cryptocurrencies in particular experienced a difficult environment characterised by plummeting prices and the headline-grabbing collapses of major crypto exchanges/intermediaries, including Voyager Digital Holdings, Inc., Celsius Network, LLC, FTX Trading Ltd. and Genesis Global Holdco, LLC.

In the insurance sector, a similar pattern emerged, with overall volumes declining markedly from 2021. Berkshire Hathaway Inc.'s $11.6 billion acquisition of property and casualty reinsurance company Alleghany Corp. far eclipsed in size the few other insurance sector deals that exceeded $1 billion in value.

Cross-Border M&A

Although there was a lower volume of cross-border transactions in 2022 due to economic uncertainty and stock market volatility, such deals remained attractive to dealmakers. Cross-border deals constituted 32% ($1.1 trillion) of global M&A, broadly consistent with the average proportion over the previous ten years (35%). Transaction volume of acquisitions of U.S. companies by non-U.S. acquirors was $217 billion, representing 6% of 2022 global M&A volume and 19% of 2022 cross-border M&A volume. In 2022, Canadian, British, Australian, Singaporean and Japanese buyers accounted for 50% of the volume of cross-border acquisitions of U.S. targets, while acquirors from China, India and other emerging economies accounted for about 8% (up modestly from 2021, where acquirors from China, India and other emerging economies were responsible for approximately 3% of cross-border deal activity).

We expect that cross-border transactions involving U.S. targets will continue to offer compelling opportunities to foreign acquirors in 2023. Conversely, the high valuation of the U.S. dollar relative to the currencies of other major economies means that overseas companies will be especially attractive acquisition targets for U.S. acquirors, which is another trend that is expected to support cross-border deal activity. Parties evaluating cross-border deals will fare better if they are well-prepared for the cultural, political, regulatory and technical complexity inherent in cross-border deals by engaging early and proactively with advisors on these topics.

Private Equity Trends

While private equity M&A in 2022 fell well short of the activity levels of the previous year, PE players displayed ingenuity and adaptability in developing transaction structures to enable dealmaking in a challenging environment. One example was the October purchase by

Blackstone of a majority stake in Emerson Electric's Climate Technologies business in a transaction valuing Climate Technologies at $14 billion, which utilized a number of different financing structures (including $2.6 billion of financing from direct lenders and $2.2 billion of seller financing) as sources of funds. Another avenue PE buyers took in 2022 was to increase their equity commitments—up to and including executing all-equity deals, such as KKR's buyout of April Group—while waiting for better market conditions to refinance some of that equity with new debt. Finally, 2022 saw an impressive number of large PE buyouts, including the $16.5 billion buyout of Citrix Systems by affiliates of Vista Equity Partners and Evergreen Coast Capital, the $10.2 billion acquisition of Zendesk by a consortium led by Permira and Hellman & Friedman, Thoma Bravo's buyouts of Anaplan ($10.7 billion), Coupa Software ($8 billion) and SailPoint Technologies ($6.9 billion) and Blackstone's purchases of American Campus Communities ($12.8 billion) and PS Business Parks ($7.6 billion).

Looking ahead, we expect there will be opportunities for private equity to be an active area of M&A in 2023. PE firms continue to have large amounts of unspent capital available and ready to be deployed. Further, as interest rates rise, companies may seek to raise cash by selling off assets, and PE actors are likely to be in the mix of potential carve-out buyers as they seek to put available cash to work. At the same time, headwinds include availability constraints and significant additional costs associated with leveraged financing that have prevailed in recent months, concerns expressed by both the FTC and the DOJ about private equity's impact on competition, and a slowdown in PE fundraising resulting from investor pessimism in the midst of increasing interest rates, rising inflation and geopolitical instability. These headwinds may present new challenges for PE in the coming year, and should be carefully considered by participants in potential private equity transactions and their advisors.

Antitrust

In a year of relatively robust M&A activity, the U.S. antitrust agencies continued to aggressively investigate and challenge deals large and small, across all industries and sectors, focusing not only on harm from mergers involving competing firms, but also on transactions implicating other theories of harm, including vertical and conglomerate theories, potential and/or nascent competition and monopsony theories (particularly involving labor markets). The hostile enforcement environment was not unexpected, given the Biden administration's expressed desire for more muscular antitrust enforcement as well as strong pronouncements in 2021 from new leadership appointed at the FTC and the DOJ that the agencies would not hesitate to vigorously challenge deals they viewed as anticompetitive. What was not initially clear, however, was whether challenges based on innovative legal theories and more novel theories of harm in this new era of enforcement would be successful.

2022 demonstrated that transacting parties who choose to test nontraditional theories of harm by fighting litigation may ultimately prevail. High-profile litigation losses for the agencies in 2022 included the DOJ's loss in its action seeking to block Booz Allen's proposed acquisition of EverWatch Corp, the DOJ's loss in its civil action seeking to enjoin United States Sugar Corporation's acquisition of Imperial Sugar Company and the dismissal by the presiding administrative law judge of the FTC's antitrust charges in Illumina's acquisition of cancer detection test-maker Grail. Further, the agencies' "just say no" approach to remedy proposals

made by merging parties was put to the test in 2022 with parties increasingly opting to "litigate the fix." One successful example of such a challenge was UnitedHealth Group/Change Healthcare, where, in response to regulatory concerns, UnitedHealth announced its intent to divest Change Healthcare's claims-editing business and, prior to the start of the antitrust trial, signed a definitive agreement to sell the business, which the district court accepted as a way to effectively restore competition over the DOJ's objection.

Parties have traditionally accounted for regulatory uncertainty through deal mechanics, including detailed regulatory commitments and reverse breakup fees. In a concerning trend, even negotiated efforts commitments—which are very common in M&A deals—are now being used by the agencies against transacting parties as evidence that the parties themselves had substantive concerns about antitrust risk, and there is increasing concern that merger agreement provisions will be used as a "road map" by the government. This development only underscores the importance of deliberate, advance antitrust analysis and planning—including not only substantive risk allocation but also optics and messaging—in consultation with advisors at the earliest possible stages of a potential transaction. For transactions that raise antitrust concerns, parties should be prepared to deal with the FTC's strong preference for divestitures in lieu of conduct remedies that require ongoing oversight to ensure compliance, as well as both agencies' strong preference for approving acquirors of the divestiture assets prior to closing rather than permitting divestiture acquirors to be identified by the parties and approved by the government after closing.

Antitrust policy at the agency level (including the adoption of new merger guidelines and informal and formal rulemaking such as the FTC's recently proposed controversial rulemaking that would ban most employee non-compete agreements), potential changes to the governing doctrinal framework (including as a result of changes to the antitrust laws through the courts and legislation) and developments in individual litigated challenges (including the outcome of the FTC's challenges to Microsoft's purchase of Activision Blizzard and to Meta Platform's purchase of virtual reality app company Within, among others) will continue to be important areas to watch in 2023. Further, significant increases in the funding allocations for the FTC and the DOJ enacted at the end of 2022 will provide the agencies with additional resources to conduct their investigations and enforcement actions. Transacting parties must carefully consider the possibility of regulatory concerns and have a clear understanding of what remedies they would be willing to offer as well as whether they are prepared to litigate—preferably with a self-imposed fix in place—if the agency's concerns cannot be resolved. Parties should anticipate potentially broader inquiries that may impose significant transaction costs and cause delays in closing timelines, and, in certain sectors such as technology, healthcare and banking, potentially more politicized challenges.

Foreign Investment Review

Regulatory scrutiny of foreign investments has increased in the United States and in jurisdictions around the world in recent years. In the United States, the Committee on Foreign Investment in the U.S. (CFIUS), an interagency committee of the federal government, reviews foreign investments in U.S. businesses and certain real estate transactions for national security implications.

In September 2022, President Biden issued an executive order regarding CFIUS review of potential national security risks associated with inbound foreign investment, representing the first time since CFIUS's establishment in 1975 that an administration provided formal guidance on specific risks that the Committee should take into account when reviewing a transaction. The Executive Order specifically instructs CFIUS to consider the following national security factors: the effect on the resilience of supply chains, potential harm to U.S. technological leadership in areas that impact U.S. national security, the cumulative effects of multiple transactions involving the same or related parties in the same industry or involving similar technologies, potential cybersecurity risks and commercial or other access to sensitive data of U.S. persons. One month later, the U.S. Department of the Treasury, which serves as Chair of CFIUS, for the first time released Enforcement and Penalty Guidelines that detail the process CFIUS will use to assess whether to impose (and the amount of) penalties, and set forth a list of aggravating and mitigating factors that will be considered.

The Executive Order and issuance of the Guidelines indicate that CFIUS will continue to closely scrutinize foreign investments in U.S. companies and businesses, and highlight the importance of thoughtfully analyzing U.S. political and regulatory implications early in the process to determine whether a transaction may attract CFIUS attention or be subject to CFIUS review. Further, governments around the world are expanding the scope of their review of foreign direct investment beyond the traditional national security focus, and are becoming more proactive in analyzing deals even where they do not fall within mandatory notification requirements. The expanding direct investment reviews in foreign jurisdictions may also extend the timeline to closing even when there are no substantive issues. Parties engaging in cross-border transactions with potential foreign investment risk therefore must carefully consider these developments in negotiating the appropriate allocation of risk and time frames, and be prepared to respond to possible (and prolonged) CFIUS and foreign direct investment scrutiny.

SPAC Trends

The special purpose acquisition company (SPAC) phenomenon boomed in 2020 and 2021, and largely busted in 2022. Both SPAC IPOs and de-SPAC M&A fell precipitously—just 85 SPAC IPOs priced in 2022 (with activity declining sharply as the year progressed, as just 16 SPAC IPOs priced during the last six months of 2022 compared to 69 in the first six months of 2022) compared to 613 in 2021, and 196 de-SPAC deals were announced over the course of 2022 compared to 289 in 2021. Further, the number of withdrawn SPAC deals surged in 2022, with a total of 65 de-SPAC M&A deals withdrawn compared to 18 deals withdrawn in 2021. The slower pace of SPAC activity reflected reduced investor interest due to weaker-than-expected performance of post-de-SPAC companies (including relative to projections), heightened regulatory and political scrutiny (illustrated by new proposed SEC rules and increased comments in the SEC review process) and longer time frames to complete transactions.

In March 2022, the SEC unveiled its long-awaited proposed rules governing SPACs. Among other significant changes, the new rules would impose additional disclosure obligations (including regarding SPAC sponsors, conflicts of interest and de-SPAC transactions) and new financial statement requirements (including with respect to financial projections) that, if

implemented, would subject SPACs to disclosure requirements that more closely match those applicable in IPOs and make the SPAC process more lengthy, burdensome and complex. The SEC's final rules are expected to be released in early 2023, although the anticipation of the proposed rules and increased SEC scrutiny are among the factors that have contributed to the whiplash in SPAC market conditions over the last two years.

Notwithstanding the likelihood of significant regulatory change and continued scrutiny in 2023, the amount of SPAC dry powder available for acquisitions and the large number of SPACs seeking targets mean that SPACs will continue to be a feature of the M&A landscape in 2023, at least in the short to medium term as existing SPACs approach their deadlines to complete business combinations (or, if they are unable to find a target, decide whether to seek an extension or dissolve, as occurred in record numbers in late 2022 with 85 SPACs liquidating in December alone). After a two-year period in which de-SPAC transactions presented many private companies with a real third alternative to M&A and an IPO, de-SPAC transactions are now more likely to make sense in a more limited set of circumstances.

Delaware Developments

The most closely watched M&A development of 2022 in the Delaware courts (and perhaps the most closely watched M&A dispute of all time) was Elon Musk's attempt to walk away from his $44 billion purchase of Twitter. Musk sought to terminate the deal by alleging, among other things, that Twitter's spam accounts exceeded the number that Twitter had publicly disclosed, which he claimed constituted a material adverse effect (MAE) that should excuse his performance under the merger agreement. Twitter filed suit in the Delaware Court of Chancery seeking to force Musk to close the deal, and following three months of high-profile discovery and pre-trial proceedings, Musk relented and the parties consummated the transaction on the originally agreed terms at the end of October 2022. Following this case and other disputes generated by pandemic-related dislocation, it remains the case that buyers seeking to establish an MAE as a basis for terminating a transaction generally must satisfy a very high bar, consistent with the prevailing philosophy in Delaware that the agreements of transacting parties generally should be respected and enforced. The Musk/Twitter saga also was a powerful reaffirmation of market expectations that the Delaware courts will enforce merger agreements in accordance with their terms.

Acquisition Financing

2022 brought a halt to a nearly unabated 12-year run of booming credit markets and record-low interest rates. Rampant inflation and fears of a recession on the horizon, among other factors, led to a marked contraction in credit availability and a slowdown in dealmaking across sectors and credit profiles. U.S. high-yield bond issuances were down approximately three quarters year-over-year—the lowest volume since 2008—while newly minted leveraged loans fell nearly two-thirds from 2021 levels. Investment-grade bond issuances fared better, but were still down significantly, with new issuances falling roughly 20% year-over-year. By year end, the average interest rate for single-B bonds had risen to 9.2%, up from under 4.7% at the beginning of January, while the average interest rate for BBB bonds more than doubled, from 2.7% to 5.8% over the same period.

Meanwhile, antitrust regulators' aggressive attitudes (described above) led to less predictable (and much longer) timelines between signing and closing of acquisitions. These two factors—a volatile and falling credit market, and the need for longer-duration acquisition financing commitments—had a compounding effect, squeezing availability for commitments of the requisite duration, and making those that were available more expensive.

In the face of these dynamics, debt-fueled M&A activity suffered, as described above. But some M&A acquirors—even those unwilling to pay the higher rates of the day—found creative ways to pursue new deals, including by turning to direct lenders for acquisition financing (who reportedly participated in the financing for six of the year's ten largest announced LBOs), accepting seller financing (as in Rev's and Searchlight's pending purchase of Global Payments' Netspend consumer business), funding their transaction with larger or more creative equity financing solutions (as in VillageMD's $8.9 billion acquisition of Summit Health) and carefully structuring deals to allow targets' existing debt to stay in place post-transaction.

2023, more than any year in recent memory, brings a unique slate of challenges and considerations for players in the acquisition financing markets, and corporate borrowers and sponsors will need to plan rigorously and be creative and flexible in order to thrive in this dynamic and challenging environment.

Tax Developments

The Inflation Reduction Act of 2022, enacted in August 2022, introduced two new taxes effective for tax years beginning after December 31, 2022: (1) a 1% excise tax on repurchases of stock of publicly traded corporations and (2) a 15% corporate alternative minimum tax (CAMT) on the financial statement income of certain large corporations. The 1% excise tax applies to a wide range of transactions well beyond conventional stock buyback programs. For example, under recently issued IRS guidance, the excise tax would apply in all-cash acquisitions to the extent the consideration is paid with cash (including borrowing proceeds) of the public target and would apply in "reorganizations" with respect to consideration received by the public target's shareholders, other than acquiror stock or securities that can be received on a tax-free basis. By introducing a parallel set of tax rules, the CAMT adds significant complexity to U.S. corporate taxation, including in the M&A context. Parties engaging with publicly traded U.S. target corporations will need to carefully consider the potential application of the excise tax, and potential acquirors of U.S. target businesses should carefully model the anticipated tax rate of the combined business, taking into account the potential application of the CAMT.

Activism and M&A

M&A-driven campaigns continued to make up a significant portion of overall activism activity in 2022. "Sell the company" campaigns were a key driver, reflecting an increasing push by activists for companies to explore or pursue transformative M&A as an alternative to perceived "stalled" or "failed" standalone strategies, and activists also commonly pushed for break-ups or divestitures in portfolio-based campaigns. In addition, some activists launched (often unsuccessful) campaigns after a transaction was announced to scuttle or sweeten an announced deal. One notable M&A-focused activism campaign was Light Street Capital's unsolicited recapitalization proposal to Zendesk following Zendesk's announcement that it had

reached an agreement to be acquired by a consortium of investors, with Zendesk succeeding in convincing shareholders—and ISS—to support the transaction recommended by the board of directors. Companies and boards across industry sectors were targeted with calls for strategic, business and portfolio reviews and also faced campaigns focused on capital allocation, margin expansion, operational changes and governance reform, including by headline activist funds like Elliott Management, JANA Partners, Carl Icahn, Sachem Head, Starboard Value, ValueAct Capital, Inclusive Capital Partners, D.E. Shaw, Third Point, Trian Partners, Corvex and newcomers such as Voss Capital, among others.

On the regulatory front, potential SEC rulemaking announced in 2022 may impact the activism landscape in the years to come, depending on how the final rules shake out. The SEC's proposed amendments to Regulation 13D-G and a related new proposed rule reaching derivatives were two of the most significant activism-related legal developments of 2022. The proposed rules would modernize the beneficial ownership reporting rules by, among other things, shortening the Schedule 13D filing deadline from ten days to five days, setting an amendment deadline of one business day after a material change, shortening the Schedule 13G filing deadlines, providing that holders of certain cash-settled derivative securities will be deemed beneficial owners of the reference equity securities and requiring expanded disclosure of activity in derivatives. The proposed amendments, which are expected to be finalized early in 2023, would represent the most significant reforms to beneficial ownership reporting requirements since the rules were adopted in 1968 and reflect the SEC's ongoing efforts to enhance transparency to investors and strike a balance among the interests of issuers and other market participants. It also remains to be seen whether proposed rules regarding disclosure of derivatives positions, which were actively opposed by certain major activist hedge funds, will reach the final rulemaking stage.

In addition, the SEC's universal proxy card rules, which would change the legal framework for director election proxy contests by mandating that the company and dissidents use and send to shareholders proxy cards listing the names of all director candidates, regardless of whether the candidates were nominated by the board or by a dissident shareholder, took effect on September 1, 2022. While activism activity had already been increasing, the universal proxy card rules are expected to increase scrutiny (by both shareholders and proxy advisory firms) of individual directors and their roles on boards, alongside an activist's broader economic critique. The upcoming 2023 proxy season will be the first in which use of universal proxy cards is mandatory, and we will begin to see whether and how the new rules impact the success rate for activists who launch campaigns for board seats, as well as the likelihood of lesser known or newer activists (or ESG activists) launching minority slate campaigns "on the cheap" using universal proxy cards. Perhaps the biggest change seen so far is how the proxy advisory firms are now approaching "building a board" across the slates offered by an incumbent board and a dissident running a competing director slate on the universal proxy card.

Looking to the year ahead, we expect that activism activity will continue to be robust and that M&A will continue to be a common campaign thesis for activists, and that the effect of recent SEC developments on activists' behavior and decisionmaking will become clearer. As activists continue to seek board representation (whether via proxy fights or settlements), the coming year will reveal whether the universal proxy card rules have an appreciable impact on

activists' inclination to nominate candidates and ability to win proxy contests or result in the typical proponents of Rule 14a-8 shareholder proposals choosing to run director candidates instead to advance their underlying agendas. And as companies and activists acclimate to the new proxy season dynamics over the next few years, another trend to watch will be whether activists who score one or two board seats are, in turn, successful in driving further M&A activity.

ESG

Environmental, social and governance (ESG) issues became more politicized in the United States in 2022 as some politicians and regulators, largely at the state level and divided along party lines, publicly staked out positions on the extent to which ESG should (or should not) affect corporate strategy or otherwise be considered by companies, asset managers and pension funds. Notwithstanding this apparent domestic ESG political backlash in some circles, ESG considerations have remained top strategic and operational priorities that have increasingly influenced the M&A landscape. Senior executives and corporate boards have leveraged M&A to advance ESG strategies and are integrating ESG considerations into due diligence and post-transaction integration processes to generate synergies, advance long-term value creation and reduce risk. Recent examples of transactions in which ESG considerations helped to drive the rationale for M&A include RWE's $6.8 billion purchase of Con Edison's clean energy business, Infrastructure Investment Fund's $8.1 billion acquisition of South Jersey Industries, SSE's $1.8 billion sale of a minority stake in its electricity transmission network to the Ontario Teachers' Pension Plan Board, Alphabet's $5.4 billion acquisition of cybersecurity firm Mandiant, BP's $4.1 billion acquisition of bioenergy firm Archaea and Chevron's $3.1 billion acquisition of Renewable Energy Group.

The influence of ESG considerations on M&A is likely to accelerate as shareholders and regulators continue to exert pressure on companies to make strategic and operational changes to address ESG risks and opportunities, in addition to enhancing board and management oversight of such matters. Notably, in the United States, new SEC rules on climate disclosures, human capital, cybersecurity and board diversity, all of which are expected to be released and/or finalized in the first half of 2023, will increase pressure on issuers to provide accurate and timely disclosures and will incentivize acquirors and targets to carefully diligence these areas to identify potential risks and vulnerabilities. ESG considerations also continue to play a role in post-transaction integration processes, particularly as corporate governance and culture, human capital management and diversity, equity and inclusion remain core investor and stakeholder concerns. Finally, we expect to see activists continue to draw on ESG critiques to strengthen their cases for change, particularly in instances where ESG-related missteps have drawn public attention, drove business crises, or led to internal or external stakeholder divisions. More broadly, it remains critical for boards and management to consider ESG factors and risks (along with all other material and relevant factors and risks) in their decisionmaking processes in order to ensure sustainable value for the company over the long term.

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As 2023 begins, there are reasons to expect that some of the major headwinds that battered M&A activity in the second half of 2022 may soon start to relent. The financing markets are not quite as hermetically sealed as they were in recent months, inflation shows pockets of easing, the impact of energy prices in Europe may not be as severe as initially feared, there is a possibility of a shallow or even no recession in the United States and many observers anticipate that the performance of the equity markets in 2023 will, at the least, be less punishing than in 2022. Nonetheless, the global economy is not out of the woods, and the risks that have depressed M&A activity in recent months are far from fully subsiding. It is difficult to predict how these trends and new developments in economic, financial, regulatory and political conditions will impact M&A in the coming year. In navigating the uncertainty, participants and their advisors should carefully analyze the risks and benefits of potential transactions, anticipate takeover threats and opportunities, proactively address changing shareholder dynamics and emerging regulatory, legislative and other risks, remain flexible and creative in transaction structuring and seek creative solutions to execute on M&A opportunities that are strategically and financially compelling.

Wachtell, Lipton, Rosen & Katz

March 10, 2023

A Sign of the Times in SEC Cyber Enforcement

The SEC yesterday announced its most recent enforcement action against a public company arising from a cybersecurity breach. *In the Matter of Blackbaud, Inc.* Blackbaud settled without admitting or denying the SEC's findings. The facts of this case illustrate yet again a theme we have sounded before: as in any corporate crisis, it is critical that companies dealing with cyber breaches take adequate steps to assure that their public statements are accurate. In addition, in this case, the SEC has delivered on its programmatic goal of raising the level of corporate penalty payments.

Blackbaud provides software that non-profit organizations use to manage data about their donors. On July 16, 2020, Blackbaud disclosed that it had discovered a ransomware attack, but also stated that the attacker did not access any donor bank account information or Social Security numbers. According to the SEC's order, within a matter of days, Blackbaud's technology and customer service personnel learned that the statement about access to sensitive information was erroneous. Nonetheless, those personnel failed to communicate that knowledge to senior management. As a result, not only did Blackbaud fail to correct the erroneous disclosure, but it also subsequently filed a Form 10-Q that failed to disclose that the attacker removed sensitive customer data. The SEC charged Blackbaud with negligence-based misrepresentations, as well as reporting violations and failure to maintain adequate disclosure controls.

The information necessary to avoid these violations existed within the organization. The by-now familiar lesson is that companies must implement procedures and controls sufficient to provide reasonable assurance that, in a crisis, senior management receives accurate and timely information, with material updates in real time. Any public statements must be carefully vetted for accuracy.

Finally, the SEC imposed a civil money penalty of $3 million in this settlement. This contrasts with the $1 million penalty that the SEC imposed in the very similar *Pearson* case in August 2021. While there can be many factors affecting the penalty amount in a given case, it is reasonable to conclude that we are seeing the SEC follow through on its well-publicized warnings that penalty amounts are going up.

John F. Savarese
Wayne M. Carlin

March 2, 2023

As Rule 10b5-1 Revisions Take Effect, the SEC Brings Another Enforcement Action

This week, there have been two important developments concerning plans implemented under SEC Rule 10b5-1, which allows for advance directives to trade securities in a manner that provides protection against claims of unlawful insider trading. *First*, the SEC's recent amendments to Rule 10b5-1 took effect on Monday, February 27. Accordingly, the new requirements (discussed here) are now operative, and companies should update their policies to comply with the revised rule and inform affected personnel, if they have not done so already.

Second, the SEC yesterday brought contested insider-trading charges against the executive chairman of Ontrak, Inc., alleging that he was in possession of material nonpublic information when he entered into two separate 10b5-1 plans, thereby rendering the plans invalid. *SEC* v. *Terren S. Peizer* (C.D. Cal. Mar. 1, 2023). The Department of Justice also announced a parallel criminal indictment.

The government alleged that Peizer entered into the 10b5-1 plans when he was aware of the likely termination of Ontrak's most important customer relationship. Accordingly, the affirmative defense under Rule 10b5-1 was unavailable because Peizer did not establish the plans in conformity with the requirements of the rule, or in good faith. When Ontrak ultimately disclosed the termination of the customer relationship, its stock price fell by 44%. The government alleges that Peizer avoided over $12 million in losses by selling stock prior to the disclosure.

The government also asserts that Peizer shopped for a broker-dealer that would not require a cooling-off period before trades could be executed. Such shopping could not succeed now, as the cooling-off periods mandated under the amended rule (at least 90 days for a director or Section 16 officer) have taken effect.

We expect the SEC will now avidly search for violations of the newly tightened standards. One method they will deploy is foreshadowed by the SEC's disclosure that the Peizer case "arose from a data-driven initiative into executive trading pursuant to 10b5-1 plans" – further underscoring the need for vigilance in revising policies and in alerting executives to the risks they face if their trading plans are not entered into, designed and operated in accordance with the SEC's new rules.

John F. Savarese
Wayne M. Carlin
Jenna E. Levine

February 28, 2023

NYSE and Nasdaq Release Proposed Compensation Clawback Rules

Last week, each of the NYSE and Nasdaq submitted to the SEC proposed compensation clawback listing standards implementing the final rules issued by the SEC in October pursuant to the Dodd-Frank Act. The proposed listing standards of both exchanges effectively track the final SEC rules. See our October 31, 2022 memorandum for an outline and discussion of the final SEC rules.

Publication in the Federal Register of the proposed listing standards initiates a 21-day public comment period, after which the SEC is expected to approve the standards. The standards will become effective upon SEC approval, which can occur no later than November 28, 2023 but may occur much sooner. Listed companies will have 60 days following the effectiveness of the listing standards to adopt a compliant recovery policy. Failure to comply will result in delisting by the applicable exchange.

With effectiveness only months away, and with the text of the final rules unlikely to change in any meaningful way, now is the time for listed companies to finalize the policies they will adopt upon effectiveness of the listing standards. Companies may also wish to consider recent ISS guidance requiring that clawback policies reach time-vesting awards in order to receive full ISS credit in the equity plan approval process. Ultimately, however, companies should adopt policies that best reflect their business objectives within the parameters of the final rules.

Adam J. Shapiro
David E. Kahan
Michael J. Schobel

February 27, 2023

Corporate Liability and Biometric Information—a *Caremark* Reminder

In 2008, Illinois enacted the Biometric Information Privacy Act (BIPA) to regulate use of information regarding an individual's physical characteristics, such as retina scans, fingerprints, voiceprints, or facial geometry scans. Groundbreaking when enacted, BIPA prohibits entities from collecting a person's biometric identifier without providing notice and obtaining written consent. The law authorizes a broad private right of action and liquidated damages for each improper use of biometric markers. Lawsuits brought under BIPA against corporate defendants have already produced enormous settlements and damages verdicts in the hundreds of millions of dollars.

Two judicial decisions this month have expanded the foreseeable limits of BIPA liability. In early February, the Illinois Supreme Court ruled that BIPA claims are governed by a five-year rather than one-year limitations period. *Tims, et al.* v. *Black Horse Carriers, Inc.*, No. 127801 (Ill. Feb. 2, 2023). And last week, that same court determined that a separate BIPA claim accrues each time a business scans or disseminates an individual's biometric identifier in violation of the Act, raising the prospect of many thousands of separate claims within each lawsuit. *Cothron* v. *White Castle Sys.*, No. 128004 (Ill. Feb. 17, 2023).

Taken together, these decisions dramatically increase the potential universe of BIPA claims. Far more potential plaintiffs will be eligible to pursue BIPA claims. And BIPA actions that survive a pleadings motion will take on increasingly outsized settlement value, as far more accrued claims may be included in each case. Other states—including New York—have recently introduced biometric privacy laws modeled after BIPA, in some cases including its expansive private right of action.

Companies that deploy or have access to biometric information should evaluate the attendant risk profile and potential mitigants. Moreover, boards of directors, increasingly at risk for claims of inadequate oversight of emergent enterprise risks, should consider now whether the use of biometric information constitutes a substantial corporate risk and whether adequate controls are in place. Given expanded opportunities for plaintiffs' lawyers and the rising tide of *Caremark* oversight claims, accelerating tort and fiduciary litigation relating to biometric information is inevitable. But attentive companies operating in affected industries can take steps now to mitigate those risks.

William Savitt
Anitha Reddy
Zachary M. David

Wachtell, Lipton, Rosen & Katz

Compensation Committee Guide

February 2023

About This Compensation Committee Guide

This Guide provides an overview of the key rules applicable to compensation committees of listed U.S. companies and practices that compensation committees should consider in the current environment. This Guide:

- ***outlines a compensation committee member's responsibilities;***
- ***reviews the composition and procedures of the compensation committee;***
- ***considers important legal standards and regulations that govern compensation committees and their members; and***
- ***recommends specific practices to promote compensation committee effectiveness in designing appropriate compensation programs that advance corporate goals.***

Although generally geared towards directors who are members of a public company compensation committee, this Guide also is relevant to members of a compensation committee of a private company, especially if the private company may at some point consider accessing the public capital markets.

This Guide also contains a sample compensation committee charter as an Exhibit. This Exhibit is intended to assist a compensation committee in performing its designated functions. However, it would be a mistake for any company to simply copy published models. The creation of charters requires experience and careful thought. It is not necessary that a company have every guideline and procedure that another company has to be "state of the art" in its governance practices. When taken too far, an overly broad or detailed committee charter can be counterproductive. For example, if a charter explicitly requires the compensation committee to review a particular type of compensation arrangement, meet a stated number of times each year or take other action, and the compensation committee has not taken that action, then the failure may be considered evidence of lack of due care. Therefore, we recommend that each company tailor its compensation committee charter and written procedures to those that are necessary and practical for the particular company.

Compensation Committee Guide

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Introduction

As we begin 2023, the role of the compensation committee continues to evolve. All aspects of executive compensation remain a central focus of the committee's responsibilities. This varied menu includes, among other things, designing and adopting incentive compensation programs that appropriately align pay with performance, implementing appropriate change in control and severance arrangements, overseeing executive compensation disclosure, and engaging with shareholders on compensation programs. And, in addition to this continuing mandate, the purview of the compensation committee at many companies has been expanded to include oversight of the company's policies and practices relating to broader human capital matters, such as gender pay equity and diversity and inclusion.

As we enter the 2023 proxy season, compensation committee members are participating more actively than ever in the process of disclosing executive compensation and soliciting shareholder feedback. The preparation of the annual proxy statement has evolved into a purpose-driven collaboration among management, the compensation committee, the compensation consultant, and external legal counsel in an effort to produce a document that serves as an executive compensation mission statement, state-of-the-union update on the performance of the business, catalogue of shareholder engagement efforts, and, last but not least, an incredibly detailed disclosure document that must comply with very technical disclosure rules, the scope and breadth of which are constantly expanding (as we saw with the finalization in 2022 of the pay versus performance and clawback rules discussed later in this Guide).

In addition to the regular cycles that surround establishing and disclosing annual compensation programs, compensation committees are also called upon to address high-priority compensation matters that arise based on evolving circumstances, including executive transitions. The ability to recruit, motivate and retain highly qualified executives remains a core mandate of the compensation committee and is essential to the long-term success of a company. Companies need to anticipate the mobility of key executives and consider the need to act decisively to secure those with proven track records by entering into long-term arrangements. Succession planning is equally vital: it is essential for boards to periodically assess the leadership pipeline and prepare for unexpected succession events.

And, importantly, compensation committees are playing a significant role in corporate transactions, where directors are often called upon to approve appropriate retention and severance protections for their corporate leaders (affording more freedom for those leaders to nimbly adapt and respond to the needs of the corporation and the shareholders in the relevant

transaction) and for non-executive employees, who often play crucial roles in the success of the transaction and the future success of the combined company.

As the role of the compensation committee grows, expands and adapts, committee members can benefit now more than ever from having a working knowledge of the key legal considerations surrounding the compensation committee's mandate. As in prior years, the primary objectives of this Guide are to review the responsibilities of public company compensation committee members and to provide information to enable these individuals to function most effectively. Because of the complexity surrounding executive compensation and other matters entrusted to the compensation committee, including with respect to tax, accounting, disclosure and governance issues, it would not be practical to expect compensation committee members to possess the technical expertise to identify and solve them all. This Guide, however, aims to serve as a resource to help orient compensation committee members to the relevant considerations and to provide directors with the information necessary to enable them to ask the right questions of management and advisors in fulfilling their duties.

I.

Compensation Committee Membership

In enlisting qualified directors to sit as members on a compensation committee, attention must be paid to the various membership requirements imposed by the securities exchange on which the company is listed, Rule 16b-3 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and state law.

A. Independence Standards of the Major Securities Markets[1]

The New York Stock Exchange (the "NYSE") and the Nasdaq Stock Market ("Nasdaq") generally require that members of listed company compensation committees satisfy the general independence standards of the applicable exchange.

1. Independence Generally

Both the NYSE and Nasdaq have adopted rules as to who can qualify as an independent director. As a general matter, these independence rules ask whether the director is a non-management director free of any material business relationships with the company and its management in the past three years (other than owning stock and serving as a director). Both markets:

- require that the board of directors of a listed company makes an affirmative determination, which must be publicly disclosed, that each director designated as "independent" has no material relationship with the company that would impair the director's independence; and

- include in the applicable rules a specific list of relationships that disqualify a director from being considered independent. These disqualifying relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. Note that ownership of a significant amount of stock, or affiliation with a major shareholder, should not, in and of itself, preclude a board of directors from determining that a director is independent.

[1] For additional discussion of the NYSE and Nasdaq independence requirements, *see* Wachtell, Lipton, Rosen & Katz, *Nominating and Corporate Governance Committee Guide*.

The following relationships generally will bar a director from satisfying the independence standards of the NYSE or Nasdaq, as applicable:

- the director is, or has been within the last three years, an employee of the company or of any parent or subsidiary of the company,[2] *except* that former employment as an interim executive officer (which under the Nasdaq rules cannot last for more than one year)[3] does not, in and of itself, disqualify a director from being considered independent following such employment;

- an immediate family member[4] of the director is, or has been within the last three years, an executive officer of the company or of any parent or subsidiary of the company;

- the director is a current partner (or employee, under the NYSE rules) of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);

- an immediate family member of the director is a current partner of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);

- under the NYSE rules, an immediate family member of the director is a current employee of the company's internal or external auditor and personally works on the company's audit;

- the director or an immediate family member was, within the last three years, a partner or employee of a firm that is the company's external auditor (or internal auditor, under the NYSE rules) and personally worked on the company's audit at any time within that period;

- under the NYSE rules, the director or an immediate family member of the director is, or has been within the last three years, an executive officer of another company where any of the company's present

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[2] Both the NYSE and Nasdaq define "company" to include a parent or subsidiary in a consolidated group with the company.

[3] The Nasdaq rules stress, however, that the board still must consider whether such former employment and any compensation received would interfere with a director's exercise of independent judgment in carrying out the responsibilities of a director.

[4] General Commentary to Rule 303A.02(b) of the NYSE Listed Company Manual defines "immediate family member" as a person's spouse, parents, children, siblings, mothers—and fathers-in-law, sons—and daughters-in-law, brothers—and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. Nasdaq Rule 5605(a)(2) defines "family member" as a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home.

executive officers at the same time serves or served on that other company's compensation committee;

- under the Nasdaq rules, the director or an immediate family member of the director is an executive officer of another entity where, at any time during the past three years, any of the executive officers of the company served on the compensation committee of such other entity;

- under the NYSE rules, the director is a current employee, or an immediate family member of the director is a current executive officer, of a company that has made payments to, or received payments from, the company for property or services in an amount that, in any of the last three fiscal years, exceeds the greater of $1 million or 2% of such other company's consolidated gross revenues;[5]

- under the Nasdaq rules, the director or an immediate family member of the director is a partner, controlling shareholder or an executive officer of any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year or $200,000, whichever is greater;[6]

- under the NYSE rules, the director or an immediate family member of the director has received during any 12-month period within the last three years more than $120,000 in direct compensation (*i.e.*, not investment income)[7] from the company, *except* for (1) director and committee fees and pension or other forms of deferred compensation for prior service (*provided* that such compensation is not contingent in any way on continued service), (2) compensation received by an immediate family member for service as a non-executive employee and (3) compensation received by a director for former service as an interim executive officer of the company;

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[5] The NYSE specifies that both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year of such other company. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

[6] The Nasdaq rules exclude from the calculation payments arising solely from investments in the company's securities and payments under nondiscretionary charitable contribution matching programs.

[7] In addition, the NYSE's focus on "direct" compensation means that *bona fide* and documented reimbursement of expenses also may be excluded. Note, however, that the NYSE considers payments to a director's solely owned business entity to be direct compensation.

- under the Nasdaq rules, the director or an immediate family member of the director received any compensation (*i.e.*, whether direct or indirect compensation)[8] from the company in excess of $120,000 during any 12-month period within the last three years, *except* for (1) director or committee fees, benefits under tax-qualified retirement plans or nondiscretionary compensation, (2) compensation paid to an immediate family member for service as a non-executive employee and (3) compensation received by a director for former service as an interim executive officer of the company for not longer than one year;[9] and

- under the Nasdaq rules, the director, while serving as an interim executive officer, participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.

Independence determinations must be based on all relevant facts and circumstances. Thus, even if a director meets all the bright-line criteria set out above, the board is still required to make an affirmative determination that the director has no material relationship with the company.

In addition, under disclosure rules promulgated by the U.S. Securities and Exchange Commission (the "SEC"), for each director who is identified as independent, the company must describe, by specific category or type, any transactions, relationships or arrangements (other than transactions already disclosed as related-party transactions) that were considered by a board of directors under the company's applicable director independence standards (*e.g.*, the NYSE or Nasdaq independence rules).

2. Independence for Compensation Committee Members

The stock exchanges require listed companies to have a compensation committee, which must be composed entirely of independent directors.[10] When evaluating the independence of any director who will serve on the compensation committee, the NYSE rules require a board of directors to consider all relevant factors that could impair independent judgments about executive compensation, including, but not limited to: (1) the

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[8] For instance, Nasdaq provides that political contributions to the campaign of a director or an immediate family member of the director would be considered indirect compensation, and, as such, must be included for purposes of the $120,000 threshold.

[9] The Nasdaq rules stress, however, that the board must still consider whether such compensation would interfere with the director's exercise of independent judgment in carrying out the responsibilities of a director.

[10] NYSE Listed Company Manual, Rules 303A.05 and 303A.07; Nasdaq Listing Rules 5605(c)(2)(a) and 5605(d)(2)(a).

source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the company; and (2) whether the director is affiliated with the company or one of its subsidiaries or affiliates. The Nasdaq rules prohibit compensation committee members from accepting any consulting, advisory or other compensatory fees from the company or its subsidiaries (other than directors' fees).

In "exceptional and limited circumstances," Nasdaq permits one director who does not meet its independence rules to serve on the compensation committee without disqualifying the compensation committee from considering the compensation matters that ordinarily would be entrusted to it had it been fully independent. Specifically, if a compensation committee is composed of at least three members, one non-independent director (who is not a current officer or employee or a family member of an officer or employee) may be appointed to the compensation committee if the board of directors, under exceptional and limited circumstances, determines that such individual's membership on the compensation committee is required by the best interests of the company and its shareholders.[11] If the board of directors takes this approach, then it must disclose either on or through the company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the company does not file a proxy, in its annual report on Form 10-K or Form 20-F) the nature of the relationship and the reasons for the determination. A member appointed under this exception may serve a maximum of two years. Since certain equity compensation arrangements that are exempted from the Nasdaq shareholder approval requirement must be approved by the company's independent compensation committee or a majority of its independent directors as a prerequisite to taking advantage of such exemption, a company with a non-independent member of the compensation committee would need to seek approval of a majority of the independent directors for this purpose.[12] The NYSE does not provide a similar exemption.

Separately, newly listed companies on the NYSE or Nasdaq need only have one independent member of the compensation committee at the time of the company's initial public offering, a majority of independent members within 90 days of listing, and a fully independent committee within one year of listing. If a newly listed Nasdaq company chooses not

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[11] Nasdaq Listing Rule 5605(d)(2)(B).

[12] Nasdaq Listing Rules 5635(c)(2) and (c)(4). Under these Nasdaq rules, shareholder approval is required before the issuance of securities when an equity compensation plan is to be established or materially amended, except for, among other things, tax-qualified nondiscriminatory employee benefits plans that are approved by the company's compensation committee and certain "sign-on" equity compensation awards that are approved by the company's compensation committee.

to have a compensation committee and to have, instead, a majority of the independent directors discharge the duties otherwise associated with a compensation committee, then the company may rely on Nasdaq's phase-in of one year for its separate requirement that there be a majority of independent directors on the board of directors.

3. Non-Employee Director

Section 16(b) of the Exchange Act provides that a company insider, such as a director or officer, is liable to the company for any profits resulting from the company insider's purchase and sale of the company's equity securities within any period of less than six months. The statute and the rules promulgated thereunder are quite broad, such that, absent an exemption, the granting, exercise and settlement of equity compensation to an officer or director of the company may be subject to this prohibition and subject the officer or director to liability for short-swing profit if the officer or director has opposite-way transactions during a six-month period. In an effort to address this issue, the SEC adopted Rule 16b-3 under the Exchange Act, which exempts, among other things, grants and awards by the company of its securities to an officer or director if approved in advance and with specificity by a committee composed solely of two or more "non-employee directors."

Under Rule 16b-3, to qualify as a non-employee director, the director cannot: (1) be an officer or employee of the company (or of a parent or subsidiary of the company); (2) receive in excess of $120,000 in compensation, either directly or indirectly, from the company (or from a parent or subsidiary) for services rendered as a consultant or in any capacity other than as a director; or (3) have an interest in any "related party" transaction for which disclosure in the proxy statement would be required pursuant to Item 404(a) of Regulation S-K.

Disclosure under Item 404(a) is required for any "transaction" since the beginning of the company's last fiscal year or any currently proposed transaction in which the company is a participant, if the amount involved exceeds $120,000 and any "related person" had or will have a direct or indirect material interest in the transaction. Under the disclosure rules, the term "related person" means any person who was at any time during the relevant period: (1) a director or executive officer of the company; (2) any nominee for director (but only if the disclosure is being presented in a proxy or information statement relating to the election of that nominee for director); (3) an immediate family member of a director, executive officer or nominee for director (if the proxy or information statement in which the disclosure is being made relates to the election of that nominee for director) of the company; or (4) a beneficial owner of more than 5% of the company's voting securities or an immediate family member of such

owner. "Transaction" for purposes of the rule includes any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships. Employment relationships and director compensation otherwise disclosed under Item 402 of Regulation S-K (*i.e.*, the executive compensation disclosure rules) need not be disclosed.

The SEC disclosure rules also make clear that, even if the company disclosed a relevant related-party transaction in the company's filings for the most recent fiscal year, such transaction will not disqualify the director under Rule 16b-3 if the transaction was terminated prior to the director's proposed service as a non-employee director.

B. Ensuring Compensation Committee Membership Compliance

It is possible that a compensation committee member will be independent under the NYSE or Nasdaq rules, but will not be a non-employee director under Rule 16b-3 under the Exchange Act. If the compensation committee has directors that are independent but are not non-employee directors, full compliance with Rule 16b-3 is still possible. As long as a compensation committee possesses at least two directors meeting the definitional requirements of non-employee directors, the compensation committee can create a subcommittee consisting solely of two or more non-employee directors and delegate responsibility with respect to matters falling within the ambit of Rule 16b-3 to the subcommittee.

C. Ensuring Independence under State Law

Transactions between a company and its directors are subjected to intense judicial scrutiny under state law because of the inherent conflict between the corporate insiders' personal financial interests and the insiders' fiduciary duty to a company and its shareholders. To avoid such heightened judicial scrutiny of compensation arrangements, compensation arrangements should be approved by, and negotiated with, directors who are disinterested with respect to the compensation decision at issue.

While Delaware courts have, in some instances, appeared receptive to arguments that economically independent directors were disqualified by alleged noneconomic conflicts of interest, the determination of independence under state law generally requires only economic independence based on a facts-and-circumstances analysis. In one opinion, the Delaware Supreme Court, addressing the independence of certain directors of Martha Stewart Living Omnimedia, Inc.,[13] specifically addressed claims that social connections and personal friendships can

[13] *Beam* v. *Martha Stewart Living Omnimedia, Inc.*, 845 A.2d 1040 (Del. 2004).

result in disqualification from a finding of independence. In deciding *Martha Stewart*, the Court held that allegations of a mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence. The court also reiterated its rejection of the concept of "structural bias," the supposition that the professional and social relationships that naturally develop among members of a board of directors impede independent decision-making.[14]

No doubt, each case of alleged director conflict of interest is different. Nonetheless, the case law supports the presumption that non-management directors are independent, unless there is real evidence to the contrary.

[14] *Id.* at 1050–52.

II.

Key Responsibilities of Compensation Committee Members

The SEC, the NYSE and Nasdaq require a listed company to have a compensation committee that assumes a number of compensation-related responsibilities. It also is advisable for compensation committees to assume certain additional responsibilities. It is important, therefore, that a compensation committee understand what is expected of it, and that it be diligent in ensuring that it appropriately and faithfully fulfills its mandate.

A. Responsibilities Imposed by the Securities Markets and the Dodd-Frank Act

1. New York Stock Exchange Requirements

The NYSE requires that all listed companies subject to its corporate governance listing standards have a compensation committee composed entirely of independent directors with a written committee charter that addresses all of the duties described in this section, that is published and printable on the company's website. The NYSE further requires that the compensation committee carry out a number of minimum responsibilities. While the responsibilities of a compensation committee may be delegated to subcommittees, for most listed companies, each subcommittee still must be composed entirely of independent directors and also have a published and printable charter.[15]

Under NYSE rules, a compensation committee must, at a minimum, (1) review and approve goals and objectives relevant to the chief executive officer's ("CEO") compensation, (2) evaluate the CEO's performance in light of such goals and objectives, and (3) either as a committee or together with the other independent directors, determine and approve the CEO's compensation based upon such evaluation. In determining the long-term incentive component of CEO compensation, the NYSE suggests that a compensation committee consider (a) the company's performance and relative shareholder return, (b) the value of similar incentive awards to CEOs at comparable companies and (c) the awards given to the CEO in past years.[16] Compensation committee responsibilities regarding CEO

[15] A listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company (known as a "controlled company") is exempt from these requirements.

[16] The NYSE clarifies that a compensation committee is not precluded from approving awards so as to comply with applicable tax laws, with or without ratification by the full board.

compensation do not preclude discussion of CEO compensation with the board of directors generally.

In addition, under NYSE rules, a compensation committee must have direct responsibility under its charter either to recommend non-CEO executive officer compensation to the board of directors, or to approve the non-CEO executive officer compensation directly.[17] This requirement means that a listed company's compensation committee must recommend, or approve, the compensation of the president, the principal financial officer (the "PFO" or "CFO"), the principal accounting officer (or, if there is no principal accounting officer, then the controller), any vice president of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs a similar policy-making function. A compensation committee also is charged with recommending to the board of directors the approval of incentive and equity-based compensation plans that are subject to board of directors' approval.[18] Additionally, the NYSE reiterates and adopts the SEC requirement that a compensation committee produce a report on executive officer compensation required to be included in the listed company's annual proxy statement or annual report on Form 10-K.

Under NYSE listing standards adopted in response to the Dodd-Frank Act, the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other advisor, and is directly responsible for the appointment, compensation and oversight of that advisor's work. The company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the advisor. Prior to retaining an advisor (other than in-house legal counsel or an advisor that consults on broad-based plans that do not discriminate in favor of executive officers or directors or provides non-customized information), the compensation committee must take into consideration all factors relevant to that advisor's independence from management, including (1) whether the advisor's firm provides other services to the company;

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[17] Section 303A.05(b)(i)(B) of the NYSE Listed Company Manual states that the written charter of the compensation committee must address the committee's direct responsibility to "make recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans that are subject to board approval". This requirement is further clarified in the commentary to the rule, which states "[n]ote also that nothing in Section 303A.05(b)(i)(B) is intended to preclude the board from delegating its authority over such matters to the compensation committee." We read this rule, together with the commentary, to mean that the compensation committee may be given either approval authority or recommendation authority over the matters covered by Section 303A.05(b)(i)(B).

[18] See *Id*.

(2) the amount of fees from the company received by the advisor's firm relative to the total revenue of the advisor's firm; (3) conflict-of-interest policies of the advisor's firm; (4) any business or personal relationships between the advisor and members of the compensation committee; (5) any stock of the company owned by the advisor; and (6) any relationships between the advisor or the advisor's firm and an executive officer of the company. These rules do not require the compensation committee to retain only independent advisors; rather, they mandate that the compensation committee consider the above six factors (and any other factors, if relevant) before selecting an advisor.

Lastly, a compensation committee must conduct an annual self-evaluation of its performance. Many consulting firms have published their recommended forms and procedures for conducting these evaluations. Consultants also have established advisory services to assist a committee with the evaluation process. A compensation committee must decide how to conduct its evaluation. In making the decision, it is not required that the directors receive outside assistance, and no specific method of evaluation is prescribed. A compensation committee may elect to do the evaluation by discussions at meetings. Documents and minutes created as part of the evaluation process are not privileged, and care should be taken not to create ambiguous records that may be used in litigation against the company and its directors.[19]

2. Nasdaq Requirements

Under Nasdaq listing standards adopted in response to the Dodd-Frank Act, Nasdaq-listed companies are now required to have a compensation committee consisting of at least two independent directors. Nasdaq also requires the compensation committee to have a formal charter, as described in greater detail in Chapter X of this Guide.

Under the Nasdaq rules, the compensation committee is responsible for determining, or recommending to the board of directors for determination, the compensation of the CEO and all other executive officers of the company.[20] The CEO is prohibited from attending meetings while the compensation committee members are deliberating or voting on the CEO's compensation under the Nasdaq listing standards. Nasdaq places no such restriction on other executive officer attendance and does not prohibit the attendance of the CEO during compensation committee discussions concerning other executive officer compensation.

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[19] For a brief discussion of the factors a compensation committee should consider in its annual self-evaluation, *see* Wachtell, Lipton, Rosen & Katz, *Nominating and Corporate Governance Committee Guide*.

[20] *See* Nasdaq Listed Company Manual Section 5605(d).

In certain circumstances, the compensation committee may include one non-independent member, as described above in Chapter I.A.2 of this Guide.

As with NYSE rules, Nasdaq rules provide that the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other advisor, and is directly responsible for the appointment, compensation and oversight of that advisor's work. The company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the advisor. Nasdaq rules require the compensation committee to consider the six factors described above in this Chapter II, but do not expressly require the compensation committee to take into consideration all of the factors relevant to an advisor's independence from management.

B. CEO and Executive Officer Compensation

While both the NYSE and Nasdaq only require that a compensation committee recommend to the full board of directors non-CEO executive officer compensation, vesting complete authority in the compensation committee for such individuals is advisable, given the requirements of the insider trading short-swing profit exemption of Rule 16b-3 under Section 16(b) of the Exchange Act and state law fiduciary duty jurisprudence, both of which provide substantial incentives for the compensation of executive officers to be determined by a committee of independent directors. A more detailed discussion of the requirements of Rule 16b-3 under the Exchange Act is set forth in Chapters I and V of this Guide.

In evaluating and setting executive officer compensation, a compensation committee should be deliberative and guided by its established compensation policy. If compensation levels are linked to the satisfaction of predetermined performance criteria, then a compensation committee should discuss whether, and to what degree, the criteria have been satisfied. That said, in response to unforeseen circumstances, such as the economic dislocations of 2020 due to the emergence of the Covid-19 pandemic, a compensation committee may find it necessary to evaluate whether preset financial goals still provide a meaningful measure of company performance. If not, the compensation committee may need to exercise discretion and rely on subjective judgments regarding individual and company performance.

Furthermore, to help ensure that compensation and severance packages are justifiable, members of a compensation committee should fully understand the costs and benefits of the compensation arrangements that they are

considering. Particular attention should be paid to severance arrangements and to all benefits provided to senior management in connection with termination of employment, as well as the impact of a change in control of the company on equity incentives and other compensation arrangements. It may be useful for a compensation committee to utilize a tally sheet, which provides a concise breakdown of the various components of a given executive officer's compensation package in scenarios that include continued employment, termination of employment and change in control of the company. And, as discussed below, given the pressure for compensation committees to consider non-executive officer compensation when setting compensation for senior executives, it would be prudent for compensation committees to be better educated as to how executive compensation arrangements fit within the broader compensation structures of the company.

C. Non-Executive Officer Compensation and Broad-Based "ERISA" Plans

There is no particular allocation of responsibilities for the compensation and benefits of a company's employees that is appropriate for every company. Companies should consider whether the compensation committee will have responsibility for employee compensation beyond that of executive officers. In addition, companies should consider whether the compensation committee will have responsibility for risk oversight in incentive compensation plans for all employees, as discussed below in this Chapter II. Limiting a compensation committee's responsibility to executive officer compensation may make sense for many companies so that directors can concentrate their limited time and resources on establishing proper incentives for those employees who are most likely to influence company performance. However, companies should be mindful that due to increased focus on pay ratios and shareholder litigation surrounding compensation issues generally, it may be useful for compensation committees to increase their oversight of total compensation expenditures (*e.g.*, bonus compensation in financial institutions). Ultimately, the full board of directors is charged with allocating compensation responsibilities, but the compensation committee may be best equipped to make recommendations to the full board of directors concerning the compensation committee's scope of responsibility.

As noted in Chapter III of this Guide, a compensation committee also may have fiduciary responsibilities under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), for certain broad-based employee benefit plans, either as a result of language in plan documents or the compensation committee's own charter, or by virtue of actually exercising such responsibilities. It is possible for a plan to state that the full board of directors or the compensation committee is responsible for

administering ERISA plans or for managing the investment of their assets, either of which will implicate ERISA's fiduciary duty rules, which in most instances require that the fiduciary act exclusively for the benefit of the plan participants. It may or may not be appropriate for a compensation committee to assume such responsibilities—as with shareholder litigation surrounding compensation issues generally, it may be more useful to limit the responsibility of boards of directors and their committees with respect to employee benefit plans—but, in any event, companies should ensure that the documentation and actual exercise of fiduciary responsibilities are consistent, and that all who are ERISA fiduciaries are aware of that fact and understand the legal responsibilities it entails.

D. Development of Compensation Philosophy

A compensation committee must develop a compensation policy tailored to the company's specific business objectives in order to evaluate, determine and meet executive compensation goals. It should be noted that a compensation policy not only makes good business sense, but the SEC requirements for the Compensation Discussion & Analysis section of the annual proxy statement (the "CD&A") require discussion of such a policy.

E. Compensation-Related Disclosure Responsibilities

A compensation committee should oversee compliance with all compensation-related disclosure requirements. Such compliance presents a significant challenge in light of the comprehensive SEC rules regarding disclosure of executive officer and director compensation. Compensation committee members should request that management review with them (1) potential disclosures that may be required in connection with compensation-related actions, including the timing requirements for any such disclosure, and (2) the nature of the information to be disclosed in upcoming public filings, including information relating to the compensation committee members themselves. Importantly, under current SEC guidance, a company that receives an SEC comment letter due to noncompliance with executive compensation disclosure rules will have to amend any materially noncompliant filings. Set forth below are the principal components of the executive compensation disclosure required each year.

1. Compensation Discussion and Analysis

The CD&A provides investors with material information necessary for an understanding of a company's compensation policies and decisions regarding the named executive officers ("NEOs"), which generally include the CEO, the CFO and the three most highly compensated executive officers other than the CEO and the CFO. In particular, the CD&A must

explain the rationale behind all material elements of NEO compensation, including the overall objectives of the compensation programs and the rationale underlying and method of determining specific amounts for each element of compensation. Under the Dodd-Frank Act, a company also must address in its CD&A whether (and if so, then how) the company has considered the results of the most recent say on pay vote in determining compensation policies and decisions.

The CD&A is considered "filed" with the SEC; accordingly, misleading statements in the CD&A expose a company to liability under Section 18 of the Exchange Act. In addition, to the extent that the CD&A is included or incorporated by reference into a periodic report, the disclosure is covered by the CEO and CFO certifications required by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). If forward-looking information is included in the CD&A, a company may rely on the safe harbors for such information.

2. Compensation Committee Report

A company must include a Compensation Committee Report in its proxy statement and its annual report on Form 10-K (incorporation by reference into the Form 10-K from the proxy statement is permitted). The Compensation Committee Report is required to state whether a compensation committee has reviewed the CD&A, discussed it with management and recommended to the board of directors that it be included in the company's proxy statement and Form 10-K. The names of the compensation committee members must appear below the report. To help ensure the accuracy of the Compensation Committee Report, the compensation committee should have detailed discussions with management concerning the CD&A in advance of the filing deadline.

3. Additional Annual Disclosure Regarding NEO Compensation

The SEC rules require quantitative elements of executive compensation of NEOs to be disclosed in tabular format, together with narrative explanations and footnotes that describe the quantitative disclosure. The central component of the tabular disclosure is the Summary Compensation Table, which discloses, by category, all compensation earned by each NEO during the prior fiscal year, including compensation attributable to salary, bonus, equity awards, change in pension value, earnings on nonqualified deferred compensation and perquisites.

Other required tables provide detailed information regarding:

- equity awards and bonus award opportunities granted to NEOs during the last fiscal year;

- outstanding equity awards at the end of the last fiscal year, including vesting schedule and exercise price, to the extent applicable;

- stock options that NEOs have exercised during the last fiscal year and NEO stock awards that have vested during the last fiscal year;

- pension plan participation by NEOs, including accumulated benefits and any payments during the last fiscal year; and

- NEO participation in deferred compensation plans, including executive and company contributions, earnings, withdrawals, distributions, and the aggregate balance at the last fiscal year-end.

Finally, companies must describe the circumstances in which a NEO may be entitled to payments and/or benefits upon termination of employment and/or in connection with a change in control and quantify the value of those payments and benefits as of fiscal year-end.

4. Director Compensation Table

The SEC rules[21] also require disclosure of a Director Compensation Table setting forth director compensation during the prior fiscal year in a format that is comparable to the Summary Compensation Table for NEOs, including disclosure with respect to perquisites, consulting fees and payments or promises in connection with director legacy and charitable award programs. Additionally, the company must provide narrative disclosure of its processes and procedures for the determination of director compensation. We discuss the considerations as to the substance of the Director Compensation Table in more detail in Chapter X of this Guide.

5. Compensation Committee Governance

Narrative disclosure regarding the governance of a compensation committee is also required by SEC rules. The narrative disclosure must describe a company's processes for determining executive and director compensation, including the scope of authority of the compensation committee; the extent to which the compensation committee may delegate its authority; and any role of executive officers and/or compensation consultants in making determinations regarding executive and/or director compensation. If compensation consultants play a role in determining executive and/or director compensation, then a company must include the disclosure described immediately below.

[21] *See* Item 402(k) of Regulation S-K, 17 C.F.R. § 229.402(k) and related Instructions.

6. Compensation Consultants and Advisors

SEC rules require annual disclosure of the role of compensation consultants in determining or recommending executive and director compensation, including:

- the identity of the consultants engaged;
- whether the consultants were engaged directly by the compensation committee;
- the nature and scope of the assignment; and
- under certain circumstances, the aggregate fees for the services provided.

The Dodd-Frank Act added another layer of requirements relating to compensation consultants, and the SEC has adopted related rules. Under these rules, a company must disclose whether the work of a compensation consultant who played any role in determining or recommending the form or amount of executive and director compensation raised any conflicts of interest, the nature of any such conflicts, and how the conflicts are being addressed.

In response to these requirements, the NYSE and Nasdaq adopted listing standards allowing a compensation committee to obtain advice from any advisor it wishes, whether or not the committee determines the advisor is independent from company management. However, as discussed above in this Chapter II, the compensation committee is required by the listing standards to consider certain independence factors before receiving advice from the advisor of its choosing. The practical result of these rules is that, generally, compensation consultants and legal advisors providing advice to compensation committees deliver annual letters to such committees containing any relevant information relating to each factor, in order for compensation committees to comply with the listing requirements.

7. Risk and Broad-Based Compensation Programs

To the extent that risks arising from a company's compensation programs for employees generally (not just executives) are reasonably likely to have a material adverse effect on the company, the SEC rules require a discussion in the annual proxy statement of the company's compensation policies and practices as they relate to risk management and risk-taking incentives. The threshold under the rules—reasonably likely to have a material adverse effect—sets a high bar for disclosure. A company should engage in a systematic process involving participants from its human

resources, legal and finance departments in which it (1) identifies company incentive compensation plans, (2) assesses the plans to determine whether they create undesired or unintentional risk of a material nature, taking into account any mitigating factors, and (3) documents the process and conclusions. If a company concludes that its programs are not reasonably likely to have a material adverse effect, then no disclosure is required; however, as a practical matter, it may be advisable to provide such disclosure because the proxy advisory firm Institutional Shareholder Services ("ISS") has encouraged disclosure about the review process and the company's conclusions and, to the extent that no disclosure is provided, the SEC may seek confirmation from the company that the risk review was done and that the company determined that disclosure was not required.

While the compensation committee need not be involved in the evaluation of risk as applied to incentive compensation arrangements themselves, the committee should satisfy itself that management has designed and implemented appropriate processes to make such evaluations.

8. Dodd-Frank Act Disclosure Requirements

In 2022, 12 years after the Dodd-Frank Act was adopted, the SEC completed the rule-making process for the executive compensation-related provisions under the Dodd-Frank Act by adopting long-awaited final rules regarding annual disclosure of the relationship between compensation actually paid to executive officers of a listed company and the financial performance of such company (the so-called "pay versus performance" disclosure) and regarding the recoupment of executive compensation (the so-called "clawback rule," discussed in more detail in Chapter V of this Guide).

a. Dodd-Frank Act Pay Versus Performance Rules

The Dodd-Frank Act required that the SEC promulgate rules requiring most listed companies (foreign private issuers, registered investment companies and emerging growth companies are exempt) to disclose the relationship between compensation actually paid to executives and the financial performance of the company in the proxy or information statements in which executive compensation disclosure is required under applicable rules. On August 25, 2022, the SEC adopted final pay versus performance rules.[22] Registrants must comply with the new disclosure requirements in proxy and information statements for fiscal years ending on or after December 16, 2022; *i.e.*, for the upcoming 2023 proxy season.

[22] *See* Pay Versus Performance, 87 Fed. Reg. 55134 (Sept. 8, 2022) (amending 17 CFR pts. 229, 232, and 240), available here.

Because the disclosure is only required to be included in proxy and information statements, companies providing executive compensation disclosure in other filings (for example, a Form 10 registration statement filed in connection with a spin-off transaction) need not include the pay versus performance disclosure. The final rules augment the proposed rules with a requirement to add additional financial performance measures beyond TSR (specifically, net income and at least one financial performance measure of the company's choice) along with a separate tabular list of the company's three to seven most important measures used to determine the level of recent NEO compensation actually paid.

The final rules require companies to disclose in a new table the following information for each of the company's last five completed fiscal years (or three completed fiscal years, for smaller reporting companies):

- the total compensation reported in the Summary Compensation Table for the company's principal executive officer ("PEO") and an average of the reported amounts for the remaining NEOs;

- the compensation "actually paid" to the PEO and the *average* compensation "actually paid" to the company's NEOs other than the PEO (calculated by starting with the Summary Compensation Table amounts and making certain adjustments to the amounts included for pensions and equity awards, discussed in more detail below);

- the company's cumulative total shareholder return ("TSR") on an annual basis, as well as the cumulative TSR on an annual basis, of the companies in the company's peer group (as identified by the company in its stock performance graph or in its CD&A) expressed as the dollar value of an initial $100 investment over the measurement period;

- the company's net income for each fiscal year; and

- an amount for each fiscal year attributable to an additional financial performance measure included in the tabular list described below, which in the company's assessment represents the most important financial measure (other than TSR and net income) used by the company to link compensation actually paid to the company's NEOs for the most recently completed fiscal year to company performance.

Using the information presented in the tables described above, companies are required to describe the relationship between the executive compensation "actually paid" and the company's (i) cumulative TSR, (ii) net income, and (iii) company-selected measure, in each case across the required measurement period. The description must also include a comparison of the company's cumulative TSR and the cumulative TSR of

the peer group over the required measurement period. This disclosure may be described as a narrative, graphically or using a combination of the two.

In addition, companies are required to provide a "tabular list" of three to seven financial performance measures, which in the company's assessment represent the most important financial performance measures used by the company to link compensation actually paid to NEOs, for the most recently completed fiscal year, to company performance. Companies may provide a single list, two lists (one for the PEO and one for other NEOs) or a separate list for each NEO. A company may include non-financial measures in the tabular list if it determines that such measures are among its three to seven most important performance measures, and it has disclosed its most important three financial performance measures.

As mentioned above, under the final rules, executive compensation "actually paid" will be calculated using compensation that companies report in the Summary Compensation Table as a starting point, with adjustments relating to pension amounts and equity awards. The adjustments required to calculate the equity award component of compensation "actually paid" illustrate the complexity of this rule. This value must include:

- for awards granted in a covered fiscal year that are outstanding and unvested as of the end of such year, the fair value of the awards as of the end of the fiscal year;

- for awards granted in any prior fiscal year that are outstanding and unvested as of the end of the covered fiscal year, the change in fair value as of the end of the covered fiscal year (from the end of the prior fiscal year);

- for awards granted in any prior fiscal year (or in the same fiscal year) that become vested as of the end of a covered fiscal year, the change in fair value as of the vesting date (from the end of the prior fiscal year);

- for awards granted in prior fiscal years that fail to vest, a deduction for the amount of fair value at the end of the prior fiscal year; and

- the dollar value of any dividends paid on any award in a covered fiscal year prior to the vesting date of the award that are not otherwise included in the total compensation for the covered fiscal year.

As noted above, this new disclosure is required for the last five fiscal years (or three fiscal years for smaller reporting companies). However, there is a "phase in" rule that allows companies, other than smaller reporting

companies, to provide the information for three years in the first proxy or information statement in which they provide the disclosure, adding another year of disclosure in each of the two subsequent annual proxy filings that require this disclosure. Smaller reporting companies may initially provide the information for two years, adding an additional year in their subsequent annual proxy or information statement that requires this disclosure. Compliance with the rules will require substantial assimilation of data and preparation of narrative and tabular disclosure, and SEC guidance released in February 2023 on various interpretive questions makes clear that there will be no shortcuts to ease the administrative burden.

b. Pay Ratio Disclosure

The Dodd-Frank Act requires that annual proxy statements include annual disclosure of the ratio between the CEO's annual total compensation and the median compensation of all other employees.

Under the rules implemented by the SEC pursuant to the Dodd-Frank Act requirement,[23] for purposes of calculating the pay ratio, companies are required to consider the annual total compensation of "all employees" (other than the CEO and contract/leased workers) as of a date selected by the company within the last three months of its most recently completed fiscal year in order to identify its "median employee" against whose compensation the CEO's will be compared. Fortunately, the rules provide companies with flexibility when identifying the median employee, including that companies may narrow the relevant employee population by using statistical sampling or other reasonable methods, may identify the median employee using either (1) annual total compensation or (2) any other compensation measure that is consistently applied to all employees included in the calculation, and may make certain cost-of-living and annualizing adjustments in identifying the median employee and annual total compensation. The SEC has also issued guidance regarding the use of statistical sampling and other reasonable methodologies that has been helpful in establishing market practices as to calculations and disclosure of the elements of the CEO pay ratio.[24]

Under the rules, companies may use the same median employee for three consecutive years, unless there has been a change in the employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in the pay ratio disclosure. Note that a public company must briefly describe in its annual

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[23] *See* Item 402(u) of Regulation S-K, 17 C.F.R. § 229.402(u) and related Instructions.

[24] *See* SEC, *Division of Corporate Finance Guidance on Calculation of Pay Ratio Disclosure*.

proxy statement the methodology it uses to identify the median employee, and, if a company changes the methodology, and if the effects of any such change are significant, then the company must briefly describe the change and the reasons for the change.

Once a company's median employee is identified, the median employee's and the CEO's annual total compensation is to be determined in accordance with the disclosure rules that prescribe the calculation of total compensation for the NEOs for purposes of the Summary Compensation Table included in the annual proxy statement. Several compensation consulting firms have created sophisticated pay ratio tracking systems, allowing companies to research the median and/or average pay ratios within their industries.[25] Based on a sampling of 200 large public companies across a variety of industries, as of fall 2022, the median CEO pay ratio was 254:1 and the average CEO pay ratio was 403:1.[26]

c. Hedging Disclosure

An SEC rule issued pursuant to the Dodd-Frank Act requires companies to describe their policies regarding the hedging of company equity securities that are held, directly or indirectly, by employees (including officers) or directors or to state that they do not have any such policies.[27] The required disclosure covers equity securities (whether or not compensatory) of a company, its parent or subsidiary and any other subsidiary of its parent. A policy may be disclosed verbatim or in summary form. The rule does not define key terms such as "hedging" or "held, directly or indirectly," but the promulgating release makes clear that these phrases should be interpreted broadly. The rule covers emerging growth companies and smaller reporting companies, but does not apply to foreign private issuers.

It is worth highlighting that this rule only requires disclosure. It does not prohibit hedging transactions or mandate that a company adopt a hedging policy. That said, the requirement to disclose the presence of absence of a hedging policy appears to have created a general practice of adopting such a policy.

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[25] *See, e.g.*, Farient Advisor's CEO Pay Ratio Tracker, which monitors the S&P 500 and Russell 3000 companies' CEO pay ratios, available here.

[26] *See* Meridian Compensation Partners LLC, *2022 Corporate Governance & Incentive Design Survey* (Fall 2), available here.

[27] *See* Item 407(i) of Regulation S-K, 17 C.F.R. § 229.407(i) and related Instructions.

9. Current Reports on Form 8-K

A company must report certain material actions and events relating to (1) the appointment, retirement, resignation or termination of service of directors, NEOs, and other specified senior officers, or (2) the compensation of NEOs, in a Current Report on Form 8-K within four business days following the occurrence of the action or event.

Under applicable SEC guidance, the disclosure obligation relating to resignation or retirement is triggered by notice of a decision, whether or not in writing, but the question of whether communications represent discussion or consideration or an actual notice of a decision is a facts-and-circumstances determination. Given the timing requirements associated with Form 8-K, it is important that members of the compensation committee and other directors be mindful of this distinction when discussing potential officer departures, especially when the departures are a result of a determination by a board of directors to act swiftly, or if there is an unexpected resignation by a covered officer. The officers covered by this reporting requirement are broader than just NEOs, and are as follows: principal executive officer, principal financial officer, principal accounting officer, principal operating officer, any person performing a similar function as that of the foregoing, and any NEO not already identified in this list.

In addition, the adoption or material amendment of a material compensatory plan, contract or arrangement with the principal executive officer, principal financial officer or any NEO must be disclosed on Form 8-K. The determination of whether a Form 8-K is required in respect of a compensatory action for a particular officer is not always black-and-white and there are meaningful exceptions that may apply with respect to ordinary-course compensation decisions, including that an award that is materially consistent with the previously disclosed terms of a plan need not be disclosed on Form 8-K if it is disclosed when Item 402 of Regulation S-K requires such disclosure. The SEC has issued a variety of guidance on these questions to help listed companies ensure they comply with the Form 8-K disclosure rules.[28]

Form 8-K disclosure is also implicated when a company elects a new director, except by vote of security holders, and when a director retires, resigns, is removed, or refuses to stand for re-election (with substantial incremental disclosure required where any director has resigned or refuses to stand for re-election because of a disagreement with the registrant,

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[28] *See* the Compliance and Disclosure Interpretations of the Corporate Finance Division of the SEC, available here.

known to an executive officer of the registrant, on any matter relating to the registrant's operations, policies or practices).

10. Conclusion

The importance of clear, thorough compensation disclosure that effectively conveys the business rationale for executive compensation decisions is greater than ever, due to the significant attention from the SEC, the media, shareholders and corporate governance activists and as a result of the heightened disclosure obligations due to the CEO pay ratio and pay versus performance rules. Companies should expect heightened scrutiny of and, accordingly, clearly explain the basis for, pay levels relative to total shareholder returns, termination and change in control payments, benchmarking practices, the existence and nature of compensation clawback policies and the relationship between particular compensation arrangements and risk.

F. Internal Controls

As part of the compensation committee's responsibility to oversee compliance with legal rules affecting compensation, it should oversee compensation disclosure procedures and the company's compensation-related internal controls. Companies should track and gather the information required under the compensation disclosure rules. Individuals to be included in the Summary Compensation Table must be determined by reference to total compensation (excluding the amounts included in the change in pension value and nonqualified deferred compensation columns).

Note that these individuals also constitute "covered employees" within the meaning of Section 162(m). As such, companies should make sure that they track all components of compensation for their executive officers, including the value of perquisites, tax gross-ups and amounts paid/accrued in connection with a termination of employment or a change in control. The expansion of Section 162(m) to make "covered employee" status permanent—once a "covered employee," always a "covered employee"—compounds the importance of maintaining accurate records of this status. Likewise, public companies must have clear rules and records regarding "specified employees," within the meaning of Section 409A of the U.S. Internal Revenue Code of 1986, as amended (the "Code"), in order to ensure compliance with the required six-month delay of deferred compensation payments triggered by a separation from service.

G. Equity Compensation Grant Policy

Companies should review the manner in which equity compensation awards are granted to employees and directors. While any given company's equity grant practices will be tailored to the company's particular business and administrative needs, each company should consider establishing a written equity award grant policy that complies with, and specifies that grants will be made in accordance with, applicable plan provisions, state law, the compensation committee charter and any applicable equity compensation plans. A comprehensive equity award grant policy will safeguard against the risk of ill-timed grants and preserve the flexibility to grant off-cycle awards under exceptional circumstances.

H. Management Succession

Planning for succession of the CEO and other senior executives is critical for the long-term success and stability of any public corporation. The board should evaluate annually the status of future generations of company leadership. To the extent that a company has not given responsibility for executive succession to its nominating and governance committee, it should consider charging the compensation committee with responsibility for management development and succession strategy.

The smoothest successions involve planned transitions where there is time for a comprehensive board process and to prepare the communications rollout to key stakeholders. No two successions are exactly alike, but most involve similar work streams for a company and its advisors:

- negotiating exit terms with the outgoing executive and employment terms with the successor;
- preparing communications and SEC filings; and
- executing an effective communications rollout.

Managing a smooth board process is paramount. The board must understand the compensation costs, including any accounting impact, for both the outgoing and the incoming executive. A company that is unprepared for succession is vulnerable. And an uncertain situation can result in negative publicity, lack of focus, internal dysfunction, activist attack/criticism and unsolicited takeover offers.

Any succession strategy should include an emergency action plan, including:

- prior identification of an interim (or permanent) successor;

- having a protocol for calling emergency board meetings and preserving the record of such meetings;

- maintaining a list of key internal and external advisors, including public relations experts who can be relied upon to act quickly on the list of actions required;

- identifying and keeping track of key stakeholders—whether inside or outside of the organization—to whom prompt outreach may be important upon announcement of the leadership change;

- understanding disclosure obligations—both as to timing and substance of the departure of the officer and replacement thereof; and

- establishing a detailed timeline and clear chain of command.

It is not unusual for a board to learn on a Friday afternoon that it needs to announce a new CEO by Monday morning. Having an emergency plan in place will make things proceed as smoothly as possible.

I. The Role of the Compensation Committee in Risk Oversight of Incentive Compensation

As discussed above, the SEC has adopted disclosure rules that require discussion in proxy statements of the board of directors' role in overseeing risk and the relationship between a company's overall employee compensation policies and risk management. In addition, the regulatory framework applicable to financial institutions, as described in Chapter VI of this Guide, requires all financial institutions to evaluate incentive compensation and related risk management, controls and governance processes, and to address deficiencies or processes inconsistent with safety and soundness.

While the compensation committee cannot and should not be involved in actual day-to-day risk *management*, directors should, through their risk *oversight* role, satisfy themselves that management has designed and implemented risk-management processes that (1) evaluate the nature of the risks inherent in compensation programs, (2) are consistent with the company's corporate strategy, and (3) foster a culture of risk-aware and risk-adjusted decision-making throughout the organization.

In overseeing risk in incentive compensation programs, the compensation committee should take into account the company's overall risk-management system and tolerance for risk throughout the organization and should discuss with members of the committee charged with risk oversight the most material risks facing the business. The ability of the

compensation committee to perform its oversight role effectively is, to a large extent, dependent upon the flow of information among the directors, senior management and the risk managers in the company. Compensation committee members need to receive sufficient information with respect to the material risk exposures affecting the company and the risk-management strategies, procedures and infrastructure designed to address them.

For instance, a non-exhaustive list of some of the features that may impact the risk profile of an incentive compensation program includes: the number of participants; whether metrics are risk-adjusted (*e.g.*, based on economic profit), and/or revenue- or transaction-based metrics; whether there are multiple metrics and whether those metrics are based on broader company or business unit performance or based on the individual's performance; and whether the compensation committee has discretion to adjust compensation up or down.

The measurement, determination and adjustment of payouts can also have an impact on the risk profile of an incentive compensation program, and can include the size of aggregate and individual payouts, whether goals and award levels are within narrower or broader ranges, and whether the awards are all-or-nothing v. tiered payouts. The maximum amount of potential revenue and potential losses or liabilities that could result from the businesses covered by the program and/or the plan also can have an impact.

If it is determined that a program has the potential to incentivize employees to assume excessive risks, then risk-mitigation techniques should be implemented to calibrate those programs to the risk profile of the organization. Potential mitigation tactics include lengthening performance periods, implementing clawbacks, deferring payment of earned performance awards, limiting the transferability of stock received in respect of equity awards, deleveraging payouts and applying downward adjustments for adverse outcomes. Chapter VI of this Guide has a more detailed discussion of these strategies and others in the context of the proposed rules applicable to financial institutions, but the fundamental principles have universal relevance.

III.

Fiduciary Duties of Compensation Committee Members

A. Fiduciary Duties Generally

Decisions by members of compensation committees with respect to executive compensation are generally subject to the business judgment rule.[29] In addition, states such as Delaware have enacted laws to permit a company incorporated in the applicable state to, in its certificate of incorporation, either limit or eliminate the personal liability of a director to the company or its shareholders for monetary damages for breach of fiduciary duty, but such laws do not allow a company to limit or eliminate the liability of a director for, among other things, (1) breach of the director's duty of loyalty to the company and its shareholders, or (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law.[30] In order to ensure directors are protected from personal liability for exercising discretion on matters that come before them, many Delaware and other corporations have acted to limit or eliminate personal liability of directors to the extent permitted by such laws.

1. Business Judgment Rule

Under the business judgment rule, directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Under this presumption, directors' decisions will not be disturbed unless a plaintiff is able to carry its burden of proof in showing that a board of directors has not met its duty of care or loyalty.

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[29] *See, e.g.*, *In re Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. 5215-VCG, 2011 Del. Ch. LEXIS 151, *45 (Del. Ch. Oct. 12, 2011); *Campbell* v. *Potash Corp. of Saskatchewan, Inc.*, 238 F.3d 792, 800 (6th Cir. 2001) ("evaluating the costs and benefits of golden parachutes is quintessentially a job for corporate boards, and not for federal courts").

[30] *See, e.g.*, *Aronson* v. *Lewis*, 473 A.2d 805, 812 (Del. 1984). The Delaware Supreme Court has ruled that the typical Delaware corporation charter provision exculpating directors from monetary damages in certain cases applies to claims relating to disclosure issues in general and protects directors from monetary liability for good-faith omissions. *Arnold* v. *Society for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1286–87 (Del. 1994). Similar provisions have been adopted in most states. The limitation on personal liability does not affect the availability of injunctive relief.

a. Duty of Care

The core of the duty of care is characterized as a director's obligation to act on an informed basis after due consideration of the relevant materials and appropriate deliberation, including the input of experts.[31] To show that a board of directors has not met its duty of care, a plaintiff must prove that director conduct has risen to the level of "gross negligence."[32] In addition, Delaware statutory law permits directors in exercising their duty of care to rely on certain materials and information.[33] Accordingly, directors charged with approving compensation arrangements should be familiar with the purpose of the arrangements and the nature of the benefits and should reasonably understand the costs; in so doing, directors may reasonably rely on the reports of their committees and advisors.

b. Duty of Loyalty

The duty of loyalty requires directors to act in the best interests of the company. Subsumed within this duty of loyalty is the directors' duty to act in good faith. In the landmark *Disney* case,[34] shareholders filed suit alleging that the board of directors did not act in good faith in approving the roughly $140 million employment and termination package of former Disney President, Michael Ovitz. The Court ruled that an appropriate measure for determining that a director has acted in good faith is whether there is an "intentional dereliction of duty, a conscious disregard for one's responsibilities." Negligence—that is, a failure to use due care—should not result in personal liability unless the director failed to act in "good faith." The Court further ruled that a director fails to act in good faith when the director (1) "intentionally acts with a purpose other than that of advancing the best interests of the corporation," (2) "acts with the intent to violate applicable positive law," or (3) "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[35]

The *Disney* decision also made clear that, although directors are encouraged to employ evolving best practices of corporate governance, directors will not be held liable for failure to comply with "the aspirational

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[31] *Smith* v. *Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (holding that, in the context of a proposed merger, directors must avail themselves of all "information . . . reasonably available to [them] and relevant to their decision" to recommend the merger).

[32] *See Aronson*, 473 A.2d at 812 ("under the business judgment rule, director liability is predicated upon concepts of gross negligence").

[33] 8 Del. Code Ann. § 141(e).

[34] *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

[35] *Id*. at 755.

ideal of best practices." In other words, directors will have the benefit of the business judgment rule if they act on an informed basis, in good faith and not in their personal self-interest, and, in so doing, will not be subject to "*post hoc* penalties from a reviewing court using perfect hindsight."[36] As the Court noted, shareholder redress for failures that arise from faithful management "must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court."[37]

In the *Disney* case, the Delaware Court also rejected a claim that the Ovitz pay package amounted to corporate waste because the contract providing for his severance pay had a rational business purpose—that of attracting Mr. Ovitz to join Disney. The "rational business purpose" test is a high hurdle for claims based on waste. Nevertheless, the Delaware Court of Chancery refused to dismiss a corporate waste claim against the Citigroup board arising from the payment of $68 million to its retiring CEO, Charles Prince.[38] In return for the $68 million payment, Prince agreed to sign non-compete, non-disparagement, and non-solicitation agreements and a release of claims against Citigroup. The Chancellor's refusal to dismiss the waste claim was based on his desire to review information regarding the value of the various promises made by Prince relative to the payments he received.[39]

In October 2011, the Delaware Court of Chancery reaffirmed the traditional principles of the common law of executive compensation in dismissing a wide-ranging shareholder challenge to compensation practices at Goldman Sachs, which included claims based on waste and the board's failure to act in good faith, to be adequately informed and to monitor the company.[40] In particular, the Court noted that "[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment,"[41] and, if the shareholders disagree with the board's judgment, their remedy is to then replace board members through directorial elections.[42]

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[36] *Id.* at 698.

[37] *Id*.

[38] *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009).

[39] *Id.*

[40] *In re The Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. No. 5215-VCG, 2011 Del. Ch. LEXIS 151 (Del. Ch. Oct. 12, 2011).

[41] *Id.* at 45.

[42] *Id.* at 46.

It should be noted that, in 2016, the Delaware Court of Chancery ordered YAHOO! Inc.[43] to produce certain books and records under Section 220 of the Delaware General Corporation Law to Amalgamated Bank, as trustee for certain stockholders, regarding the hiring and subsequent firing of YAHOO!'s Chief Operating Officer, Henrique de Castro. In its opinion, the Court found similarities to the *Disney* case: a CEO hiring a number-two executive, poor performance by the number-two executive and a no-fault termination that resulted in a large payment to the terminated executive (*i.e.*, approximately $60 million in cash and accelerated equity awards). According to the Court, based on publicly available information and certain information provided by YAHOO!, there was a credible basis to suspect wrongdoing, including possible breach of fiduciary duties, by the board and the CEO, and possible corporate waste.[44] Although the opinion does not represent a finding by the Court that there has in fact been a breach of fiduciary duty or corporate waste, it highlights the importance of providing material information to a board of directors in executive compensation determinations and of facilitating a meaningful review and evaluation of such information before approval of compensation actions.

2. Adopting or Amending Compensation Arrangements in the Context of Corporate Transactions; Conflicts of Interest Transactions

Adopting or amending compensation arrangements in the context of takeover activity or certain negotiated transactions can result in heightened judicial scrutiny. If the adoption or amendment of a compensation arrangement is deemed a defensive measure taken in response to an actual or threatened takeover, then the adoption will be subject to judicial review under an "enhanced scrutiny" standard,[45] which looks both to the board of directors' process and its action. That said, a compensation arrangement will not be subjected to enhanced scrutiny merely because a board of directors adopts a compensation arrangement in the face of a takeover threat; in order for enhanced scrutiny to apply, a board of directors must have entered into the compensation arrangement as a defensive measure.[46]

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[43] *Amalgamated Bank, Trustee for the Longview LargeCap 500 Index Fund and the LongView LargeCap 500 Index VEBA Fund* v. *YAHOO! Inc.*, 132 A.3d 752 (Del. Ch. Feb. 2, 2016).

[44] *Id.* at 783–84.

[45] *See, e.g.*, *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Gilbert* v. *El Paso Co.*, 575 A.2d 1131, 1143–44 (Del. 1990) (subjecting the "golden parachute" employment arrangement among target's defensive measures to enhanced scrutiny).

[46] *See, e.g.*, *Moore* v. *Wallace Computer Servs.*, 907 F. Supp. 1545, 1556 (D. Del. 1995) ("In addition . . . the facts [sic] that such agreements are commonplace among chief executives of major companies and that Cronin's severance package was identical to that

If the arrangement was adopted as a defensive measure, the directors carry the burden of proving that their process and conduct satisfy a two-pronged test (known as the *Unocal* standard):[47]

- a board of directors must show that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," which may be shown by the directors' good-faith and reasonable investigation; and

- a board of directors must show that the defensive measure chosen was "reasonable in relation to the threat posed," which may be demonstrated by the objective reasonableness of the course chosen.[48]

If directors can establish both prongs of the *Unocal* test, their actions will receive the protections of the business judgment rule. While the *Unocal* standard still provides a board of directors reasonable latitude in adopting defensive measures,[49] executive compensation plans adopted in response to a takeover threat may result in a court more closely examining a board of directors' process and actions.[50] Therefore, adopting or amending change in control *employment* arrangements in advance of an actual or threatened takeover may be advisable whenever possible.[51]

When an actual conflict of interest that affects a majority of the directors approving a transaction is found, Delaware courts apply the most exacting standard, the "entire fairness" review, which requires a judicial

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of his predecessor, persuade this Court that the adoption of the golden parachute agreement was not a defensive measure.").

[47] *Unocal*, 493 A.2d at 955.

[48] *Id*.

[49] *See, e.g.*, *Unitrin, Inc.* v. *American Gen. Corp*., 651 A.2d 1362, 1388 (Del. 1995).

[50] *See Gilbert*, 575 A.2d at 1143–44 (applying *Unocal* standard in reviewing defensive measures, including golden parachutes and ESOPs, where "everything that [defendant directors] did was in reaction to [the] tender offer"); *Int'l Ins. Co.* v. *Johns*, 874 F.2d 1447, 1459 (11th Cir. 1989) (stating that the intent of the company's board in enacting a golden parachute is determinative of the standard used; when enacted in response to a takeover threat, the *Unocal* enhanced scrutiny standard applies).

[51] *See Moore Corp. Ltd*. v. *Wallace Computer Servs., Inc*., 907 F. Supp. 1545, 1556 (D. Del. 1995) (refusing to apply *Unocal* scrutiny to golden parachutes negotiated before a tender offer, but applying *Unocal* enhanced scrutiny to the failure to redeem a poison pill); and *In re Western Nat'l Corp. S'holders Litig.*, 2000 WL 710192 (Del. Ch. May 22, 2000) (applying business judgment rule to board-approved employment agreement granting large severance payment and accelerated vesting of options because applicable employment agreement was adopted before potential acquirer was a shareholder and agreement was negotiated and recommended by disinterested directors).

determination of whether a transaction is entirely fair to shareholders.[52] Such conflicts may arise in situations where directors (1) appear on both sides of a transaction, as in adoption of compensation arrangements for the directors themselves, or (2) derive a personal financial benefit that does not generally benefit the company and its shareholders.[53] In determining whether a transaction is entirely fair, "the court must consider the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide."[54]

In the context of director and executive compensation, entire fairness scrutiny is most likely to apply where directors have approved a compensation plan specifically for themselves. Even if the compensation arrangements directly benefit insider directors, their approval should be protected by the business judgment rule if approved by an independent committee or by the disinterested directors.[55] However, when directors who directly benefit from a proposed plan are delegated the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plan as it relates to the company's shareholders.[56]

B. Fiduciary Duties under ERISA

ERISA is the federal law governing employee retirement and welfare benefit plans. Although its original enactment was spurred by a congressional concern for adequate funding of traditional defined benefit pension plans, ERISA has imposed from its inception a comprehensive set of requirements for many types of broad-based benefit plans, including retirement plans such as defined benefit pension plans (including cash balance plans), the well-known "401(k)" plan, employee stock ownership plans ("ESOPs"), and medical and other welfare plans. A key component of ERISA is the imposition of fiduciary duties and liabilities on individuals and entities that become fiduciaries in respect of such plans under ERISA. ERISA fiduciary duties are said to be the highest of such

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[52] *See, e.g.*, *Weinberger* v. *UOP, Inc.*, 457 A.2d 701, 710–11 (Del. 1983), *aff'd*, 497 A.2d 792, Del. Supr., July 9, 1985.

[53] *See, e.g.*, *Ivanhoe Partners* v. *Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987).

[54] *Cinerama, Inc.* v. *Technicolor*, 663 A.2d 1134, 1140 (Del. Ch. 1994).

[55] *See Tate & Lyle PLC* v. *Staley Continental, Inc.*, 1988 Del. Ch. LEXIS 61, *20–21 (Del. Ch. May 9, 1988) (permitting outside directors to approve compensation for insider directors after conducting reasonable inquiry and obtaining full board of directors' approval).

[56] *See, e.g.*, *id.* at *20–22 (invalidating rabbi trusts covering both inside and outside directors due to conflict of interest).

duties known to the law. It is critical, therefore, for compensation committee members to understand the extent to which they themselves may be liable as ERISA fiduciaries.

A person may become a fiduciary under ERISA by being specifically named as such in a plan document, by being identified as such under a procedure set forth in the plan document, or by exercising responsibilities that ERISA considers to be fiduciary in nature. Note that a named fiduciary may delegate fiduciary responsibilities to another person, who thereby becomes a fiduciary. However, a person who appoints a fiduciary is himself or herself a fiduciary with respect to that appointment. Compensation committees may, therefore, be considered ERISA fiduciaries for many reasons, including as a result of language in their charters or in plan documents, as a result of exercising administrative responsibilities for ERISA plans, by virtue of involvement in managing the assets funding ERISA plans, or because the compensation committees appoint plan fiduciaries (which may include employees of the company as well as third-party institutions such as trust companies or investment managers).

The decision to adopt or terminate a particular compensatory arrangement, even if the arrangement is itself subject to ERISA, is generally considered a "settlor function" and is not subject to ERISA's fiduciary duty rules. However, once an ERISA plan is adopted, fiduciary duties may attach to determinations made pursuant to that plan. ERISA requires that fiduciaries exercise their fiduciary duties prudently and solely in the best interests of plan participants.

In general, fiduciary duties under ERISA fall under the statutorily mandated "prudent man standard of care." Such standard requires a fiduciary to act solely in the interest of the ERISA plan participants, for the exclusive purposes of providing benefits to the plan participants and of defraying reasonable expenses of administering the plan, all with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use.[57] A wide body of law has developed under this standard, which includes duties to disclose material information to plan participants, to operate ERISA plans in accordance with their terms and applicable law, and to avoid conflicts of interest. Consequently, while it is not impermissible for an individual or entity that acts as a plan fiduciary also to have another role that affects the plan, fiduciaries must be alert to the possibility that their ERISA duties and their responsibilities to the shareholders may conflict, presenting special legal issues that must be addressed.

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[57] *See* 29 U.S.C. § 1104(a).

Consider, for example, the common situation in which a person who has responsibility for selecting the investment choices to be offered to 401(k) plan participants—including company stock—learns, in his or her capacity as a member of a board of directors, of confidential information that may, when announced, cause a significant and long-term drop in the company's stock price: the individual's fiduciary duty under ERISA to offer only prudent investment choices to plan participants could come into conflict with the individual's duty under the federal securities laws not to use confidential information before it is made public and with a business strategy being pursued on behalf of shareholders generally. This type of fact pattern has generated many lawsuits against directors and executives with respect to actions taken in respect of ERISA plans, where an effective legal defense was oftentimes a judicially created presumption of prudence.[58] However, the U.S. Supreme Court has eliminated this presumption in favor of a fact-specific approach in the evaluation of such claims.[59] This fact-specific approach creates a high bar for claims involving nonpublic information, by requiring that (1) the complaint contain a plausible allegation that an alternative action could have been taken consistent with securities law and (2) a prudent fiduciary in like circumstance would not have viewed such alternative action as more likely to harm the fund than to help it. Most cases have failed to proceed under this newer standard, given the complex interplay between the securities laws and ERISA. Nonetheless, a recent stock drop case involving corporate officers serving as ERISA fiduciaries with insider knowledge of undisclosed losses at the company made its way to the U.S. Supreme Court.[60] Although the court did not rule on the merits, it remanded the case, and, of significance, directed the Second Circuit to determine whether to consider the views of the SEC regarding the conflict between the ERISA-based duty to disclose versus the objectives of corporate disclosure requirements and insider trading rules under federal securities laws. The parties ultimately settled through mediation and the Second Circuit made no ruling on the conflict between the duty to disclose and insider trading rules.

Many companies have chosen to have company employees and/or independent third parties, rather than members of their board of directors, serve as ERISA fiduciaries. In such cases, however, the responsibility to appoint those fiduciaries often rests with the full board of directors or the compensation committee. As noted above, those persons who appoint fiduciaries are themselves fiduciaries and, while such persons do not have the same breadth of ERISA fiduciary responsibility, they must still

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[58] *See, e.g.*, *Moench* v. *Robertson*, 62 F.3d 553 (3d Cir. 1995).

[59] *See Fifth Third Bancorp* v. *Dudenhoeffer*, 134 S. Ct. 2459 (2014).

[60] *See Retirement Plans Committee of IBM* v. *Jander*, 2020 WL 201024 (Jan. 14, 2020).

exercise their appointment powers prudently and solely in the best interests of plan participants (*e.g.*, the appointees must be qualified to serve as ERISA fiduciaries). This continued ERISA fiduciary responsibility also includes exercising some oversight over the performance of the appointees, generally through a duty to monitor the activities of the appointees.

The satisfaction of ERISA fiduciary duties relies heavily on "procedural prudence," so it is important for all ERISA fiduciaries to follow appropriate procedures, to have full access to all necessary information and expert advice pertaining to their duties, and to keep careful records of their deliberations, decisions and actions when acting in a fiduciary capacity. Boards of directors and compensation committees who have delegated ERISA fiduciary duties to qualified appointees also should receive periodic reports regarding the plans being administered by their appointees and satisfy themselves that the appointees are fulfilling their delegated functions. Obtaining and maintaining an appropriate level of ERISA fiduciary insurance for all persons acting as fiduciaries is highly recommended. Although ERISA fiduciaries may not be indemnified using the assets of ERISA plans, companies may be permitted to further indemnify their ERISA fiduciaries through bylaws or corporate resolutions.

IV.

Methods of Compensation

A. Understanding and Pursuing Compensation Goals and Objectives

"Pay-for-performance" has been the mantra for "best practices" in executive compensation for decades. While compensation programs should be designed so that compensation increases as corporate or individual performance metrics are met or exceeded, the Covid-19 crisis has highlighted the importance and challenges of designing compensation programs that are responsive to unforeseen events while incentivizing behavior that preserves and enhances the long-term value of the company.

The highest priority for a company in designing a compensation program should be to create economic incentives and encourage particular behaviors. Companies should balance the need to retain employees and incentivize them in a manner that rewards growth and appropriate risk-taking with the need to preserve the business. With respect to performance-based compensation, companies should select performance criteria that reflect true measures of operating performance and long-term value creation, and a compensation committee may consider preserving some negative discretion to adjust award amounts downward in the event of anomalous results.

Careful thought should go into the structure and design of compensation programs to help ensure that they protect against the creation of short-term windfalls for employees that do not match long-term sustained benefits for shareholders. Moreover, a compensation committee should seek programs that it believes are in the best interests of shareholders generally, not programs that are merely intended to appease individual shareholder critics and the media at any given moment. These groups may have short-term interests that do not take into account the future well-being of the company and they may have interests that are inconsistent with the interests of shareholders generally.

The different types of compensation described below are not mutually exclusive alternatives. Companies can and should consider granting a mix of types of compensation based on their business needs. A compensation committee should determine, in its business judgment based on the particular needs of the business, the appropriate mix of fixed compensation (*e.g.*, annual base salary) and variable compensation (*i.e.*, short-term and long-term performance incentives), as well as the form of compensation (*e.g.*, stock options, restricted shares, restricted stock units or cash-based payments). No particular compensation vehicle should be

off the table simply because it has been criticized in the media or by shareholder activists, although committees should understand how awards will be considered by proxy advisory firms in connection with the "say on pay vote" recommendation.

Due to the 2017 elimination of the performance-based compensation deduction exemption under Section 162(m) (described in Chapter V of this Guide, below), incentive compensation awards can no longer be structured in a manner that ensures full tax deductibility under Section 162(m). While these changes have increased the after-tax cost of senior management compensation, they have also presented an opportunity for companies to take a fresh look at their compensation plan designs. From a corporate tax standpoint, the changes placed discretionary bonuses and service-based awards on equal footing with performance-based arrangements and provided companies with greater flexibility to address the impact on performance of unexpected events without compromising the deductibility of an award. Despite the elimination of the Section 162(m) performance-based compensation exception, sound incentive design and shareholder expectations have resulted in companies continuing to link pay to performance and there have not been dramatic design changes, although we have seen companies be more willing to exercise discretion to modify or adjust performance goals to address unexpected circumstances or events.

B. Equity Compensation

The manner in which most companies provide executives with equity compensation continues to evolve. We have set forth below the material characteristics of various types of equity compensation awards to aid committee members in understanding the issues involved in the design of equity compensation alternatives. To facilitate decision-making with respect to the granting of equity compensation awards, compensation committees should familiarize themselves with the economic, tax and accounting implications of granting different forms of equity compensation.[61]

The discussion below is limited to considerations regarding equity awards granted by U.S. corporations to U.S. taxpayers, but consideration should also be given to the securities and disclosure and tax implications of granting different forms of equity compensation in non-U.S. jurisdictions.

[61] The U.S. Internal Revenue Code provisions and the stock exchange rules referenced in this Chapter IV are outlined and discussed more fully in Chapter V of this Guide.

1. Stock Options

Despite their fall from grace over a decade ago, stock options can be a valuable tool to incentivize employees. Stock options provide employees with the opportunity to buy shares of company stock at a fixed price during a specified period of time, allowing the employee to benefit from appreciation in the value of company stock. Stock options typically have an exercise price equal to the fair market value of the underlying stock on the date of grant. Vesting of stock options generally is contingent upon an employee's continued employment for a specified period of time (service-based options) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based options) or may result in vesting at an earlier point in time (performance-accelerated stock options).

The principal benefits and drawbacks to granting stock options are as follows:

- ***Benefits***
  - Generally not subject to Section 409A of the Code if the following conditions are met: (1) the strike price is equal to or greater than fair market value on the grant date, (2) the option relates to "service recipient" stock, and (3) the stock option does not otherwise include any deferral feature.
  - Because stock options are not considered outstanding shares until exercised, they are not counted in the denominator for calculating earnings per share.
  - Optionees only realize a benefit from the award if the value of the stock exceeds the exercise price and do not realize any loss if the stock price never exceeds the exercise price, therefore encouraging stock option holders to pursue strategies to increase stock price, affording shareholders increased opportunities to recognize gains.
  - Because stock options generally are not taxable until exercise, optionees have a degree of control over when they incur taxes with respect to stock options. Further, under the 2017 Tax Reform Act, employees of private companies can enjoy a deferral of tax for up to five years after the exercise of stock options, subject to certain requirements.
- ***Drawbacks***
  - An accounting charge must be recognized following the grant even though no economic benefit may be derived by the optionee

(although it is possible that the value ultimately achieved by the optionee will exceed the charge recognized).

- Because stock option holders receive a benefit if the stock price increases, but have no downside protection if the price decreases, there is a perception that stock option holders may be incentivized to pursue riskier strategies to cause stock prices to peak.

- Likely disconnect between amount of pay received by optionee and amount of expense to company.

- Because optionees typically have a long period during which to exercise their stock options, a well-timed exercise can result in significant gain even where the company's stock does not provide commensurate long-term gain for shareholders.

- The grant of stock options results in an increase of so-called "overhang," which ultimately can result in dilution of existing shareholders if the stock options are exercised. We note that institutional shareholders often measure dilution, taking into account outstanding stock options and/or even reserved option shares.

- In a falling stock market, underwater stock options may lose retentive value.

- Internal controls surrounding the grant of stock options have increased in complexity.

- ISS does not consider time-based stock options to be performance-based compensation for purposes of its "pay-for-performance" analysis.

2. Stock Appreciation Rights

Stock appreciation rights ("SARs") provide employees the right to receive an amount equal to the appreciation in value of company stock over a certain price during a specified period of time. Upon the exercise of a SAR, the company pays the employee cash, stock or a combination thereof equal to such net appreciation value.

The principal benefits and drawbacks of granting SARs generally are the same as granting stock options, except:

- ***Benefits***
  - SARs that may be settled only in cash are not considered equity compensation under NYSE and Nasdaq rules. Accordingly, no shareholder approval under such rules is required with respect to plans under which only these awards may be granted.
  - The exercise of SARs does not require the holder to pay an exercise price for which he or she may need to borrow against the exercise proceeds or engage in a broker-assisted cashless exercise, either of which must be structured to comply with applicable securities laws and the company's policies regarding hedging and pledging and insider trading.
  - SARs settled in cash instead of stock will not result in equity dilution.
- ***Drawbacks***
  - SARs settled in cash instead of stock will not increase the employee's holdings of company stock.
  - SARs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the SARs).
  - SARs settled in cash will require an outlay of cash by the company.

3. Restricted Stock

Restricted stock is a grant of shares of company stock subject to specified vesting provisions and limitations on transfer. Vesting of restricted stock typically is contingent upon an employee's continued employment for a specified period of time (service-based restricted stock) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based restricted stock) or may result in vesting at an earlier point in time (performance-accelerated restricted stock).

The principal benefits and drawbacks of using restricted stock are as follows:

- ***Benefits***
  - Holders of restricted stock share in both increases and decreases in the company's stock price, which directly aligns the interests of restricted shareholders with shareholders.
  - From the perspective of employees, restricted stock may represent a more tangible benefit than stock options.
  - Holders of restricted stock can vote and receive dividends.
  - The ability of employees to make an election under Section 83(b) of the Code to recognize the value of the restricted stock at the time of grant may enable an employee to achieve a favorable tax result if the value of the restricted stock appreciates during the vesting period (although such elections are uncommon at public companies).
  - Restricted stock generally is not subject to Section 409A of the Code.
  - Holders of restricted stock will realize value even if the price of company stock decreases during or after the vesting period. Accordingly, restricted stock may have greater retentive value than stock options in a down market and may be less likely to encourage risky strategies than could be the case with stock options or SARs.
- ***Drawbacks***
  - Employees will receive some value from restricted stock even if the stock performs poorly.
  - ISS discourages the payment of dividends or dividend equivalents on unvested equity awards under its Equity Plan Scorecard (the "EPSC"); companies should be aware of this when granting restricted stock and may decide that dividends instead will accrue and not be paid unless and until the underlying shares become vested.
  - Shares of restricted stock are outstanding and are included in the denominator for computing diluted earnings per share.

4. Restricted Stock Units

A restricted stock unit ("RSU") is a contractual right to receive a share of company stock or cash equal to the value of a share of company stock. Settlement of RSUs (*i.e.*, delivery of the company shares or payment of cash) occurs on a fixed date or dates or upon the occurrence of a specified event or events. As is the case with restricted stock, vesting of RSUs may be service-based, performance-based and/or performance-accelerated.

The principal benefits and limitations of using RSUs as a means of compensation are the same as those of restricted stock, except:

- ***Benefits***
  - RSUs that can be settled only in cash are not equity compensation under NYSE and Nasdaq rules. Accordingly, no shareholder approval is required with respect to cash-based RSUs under such rules.
  - RSUs that can be settled only in cash are not equity securities under U.S. federal securities laws, and therefore no registration statement is required to be maintained with respect to such awards.
  - RSUs that are ultimately settled in cash instead of stock will not result in shareholder dilution.
  - Because RSUs are not "property" under Section 83 of the Code and merely represent a general unsecured promise to pay a future amount, an employee may postpone taxation beyond vesting (the company's deduction is similarly delayed) until such time as the RSUs are settled. Accordingly, RSUs can allow employees to retain an interest in company stock and, consequently, company performance for an extended period of time without triggering a tax liability.
  - RSUs could be structured (if done in advance) to delay delivery of stock to a future date post-termination of employment, which could help align executives' interests with shareholders and facilitate enforcement of clawbacks.
  - Under the 2017 Tax Reform Act, employees of private companies can enjoy a deferral of tax for up to five years after the vesting of RSUs, subject to certain requirements.

- ***Drawbacks***

  - If RSUs may be settled only in cash, or in stock or cash at the company's election, they are not reportable in the proxy statement beneficial ownership table.

  - RSUs settled in cash instead of stock require a cash outlay by the company, and unless such settlement could jeopardize the company as an ongoing concern (a high standard), Section 409A of the Code does not allow the company to delay payment even if such a cash outlay could significantly impair the company financially (*e.g.*, cause it to be in default under its credit facility).

  - RSUs settled in cash instead of stock will not increase the employee's holdings of company stock and typically do not count towards share ownership requirements.

  - RSUs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the RSUs).

  - RSUs that provide for the deferral of payment post-vesting may be subject to Section 409A of the Code, depending on their terms, which can limit a company's flexibility to modify such awards (*e.g.*, accelerate settlement, or further delay settlement, of previously vested RSUs).

  - Because RSUs are not property, grantees cannot make an election under Section 83(b) of the Code to provide favorable tax treatment for post-grant appreciation.

C. Retirement Programs

In addition to the other compensation programs described above, compensation committees often provide executives with retirement benefits under either defined contribution plans (*e.g.*, 401(k) plans) or defined benefit plans (*e.g.*, pension plans that provide a fixed retirement benefit based on years of service and final pay). These arrangements can either be (1) "qualified plans," which provide the company with tax benefits, but generally, must be provided to a large portion of the employees and are subject to limitations on, among other things, the aggregate benefit payable to participants under the plans and complex rules under the Code and ERISA, or (2) "nonqualified plans," which may be limited to senior executives and provide them with additional retirement benefits that are not subject to the limitations imposed under the Code and ERISA.

Compensation committees should be sure to understand the applicable funding and contribution requirements of the company's tax-qualified retirement plans. The obligations under these plans, as well as the value of assets funding those obligations, are disclosed in a company's financial statements, although a company's management and compensation committee should be aware that the manner in which these obligations are calculated for accounting and reporting purposes differs from the manner in which these obligations are calculated under ERISA for purposes of determining funding obligations. And, as discussed in Chapter III of this Guide, boards of directors should understand the ERISA fiduciary law implications of maintaining qualified retirement plans.

Compensation committees should be sure to understand the cost of any nonqualified retirement plan arrangements, including any implications that increases in annual compensation may have on that cost. Moreover, Compensation Committees should be aware that, since these programs generally represent an unsecured promise by the company to pay amounts to executives in the future, which constitute accrued liabilities that appear in a company's financial statements, they effectively result in executives being creditors of the company. As creditors of the company, executives with large nonqualified retirement benefits may be incentivized to act more conservatively with regard to risk-taking and capital investment, especially as they approach the stated retirement age when their benefits become payable.

D. Perquisites

Perquisites should be provided to executive officers only with full disclosure to the compensation committee. Any compensation or other benefit received by any officer from any affiliated entities (using a low threshold for the definition of an affiliated entity) should be carefully reviewed to confirm compliance with the company's code of business conduct and ethics and applicable law. Perquisite programs and company charitable donations to any organizations with which an executive is affiliated should be carefully scrutinized to make sure that they do not create any potential appearance of impropriety. As a reminder, perquisites provided to NEOs that in the aggregate are equal to $10,000 or more in any given year must be disclosed in the proxy statement.

Regulators and institutional shareholders are closely scrutinizing executive compensation in general and executive perquisites in particular. In response, many companies have modified or eliminated perquisite programs in recent years, in some cases replacing the value of such benefits with other forms of compensation that are subject to less scrutiny (such as base salary) or requiring that executives reimburse the company for the incremental value of the perquisites the company provides.

While the rhetoric may, in many cases, be overblown, procedure and disclosure are often as important as the substance of underlying compensation packages. And while criticism cannot always be avoided, actions taken by a well-informed and objective compensation committee, which are then appropriately disclosed to shareholders, will be shielded from liability.

V.

Laws and Rules Affecting Compensation

A. Section 162(m) of the Internal Revenue Code

1. General

Section 162(m) generally disallows a publicly traded company's federal income tax deduction for compensation paid to "covered employees" in excess of $1 million during a company's taxable year. This $1 million deduction limit covers all types of compensation, including cash, property and the spread on the exercise of options. Since the enactment of Section 162(m) in 1993, public companies structured their executive compensation programs to take advantage of an important exception to this deduction limitation for "performance-based compensation" keyed to a pre-established, objective, nondiscretionary goal and formula.[62] However, the 2017 Tax Reform Act eliminated this exception.

Accordingly, companies no longer need to structure their compensation programs to comply with the requirements of the "performance-based compensation" exception, including (1) subjecting their cash bonus plans to shareholder approval, (2) setting forth permissible performance goals in their equity plans, and (3) seeking shareholder approval of applicable performance goals every five years. Further, individual award limits are no longer necessary in equity plans from a tax planning perspective (other than for tax-qualified incentive stock options); however, proxy advisory firms such as ISS have issued statements making it clear that in their view companies should continue to use performance-based compensation structures and that plans should continue to contain individual award limits, even without the benefit of the performance-based compensation deduction exception under Section 162(m).

Elimination of the performance-based exception has resulted in a significant increase in disallowed tax deductions and other important consequences, which we discuss below. Nevertheless, to date, companies have accepted the lost deductions as a necessary consequence of the competitive marketplace for talent. And by now, most incentive compensation plans and arrangements and the manner in which they are administered have been modified as necessary to eliminate the framework and limitations of the now-defunct performance-based exception. It is,

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[62] Note that for financial institutions receiving government assistance under the Troubled Asset Relief Program ("TARP") and for certain health insurance providers, the deduction limitation has been lowered from $1 million to $500,000 and there has been no exception for performance-based compensation for some time.

however, important to ensure that the company is maintaining proper internal controls to ensure compliance with the broader limitations on deductible compensation.

2. Expansion of Impacted Companies and "Covered Employees"

Prior to the 2017 Tax Reform Act, Section 162(m) generally only applied to the compensation payable to "covered employees" of companies with publicly traded equity securities. The 2017 Tax Reform Act and the proposed regulations have expanded the scope of entities subject to Section 162(m) to include the potential coverage of foreign private issuers, companies with public debt, and partnerships, and also confirm that newly public companies are no longer eligible for transition relief. In a reversal of prior Internal Revenue Service ("IRS") guidance, the proposed regulations apply the Section 162(m) deduction limitation to a public company's distributive share of a deduction for compensation paid by a partnership to the company's covered employees, subject to certain grandfathered arrangements in effect on December 20, 2019.

The 2017 Tax Reform Act also substantially expanded the original definition of "covered employees" for purposes of Section 162(m). The definition had been limited to a company's principal executive officer and the three other most highly compensated executive officers who are required to be named in the company's executive compensation disclosure under SEC disclosure rules, but did not cover the company's principal financial officer. In addition to including principal financial officers, the 2017 Tax Reform Act definition imposed permanent "covered employee" status on any officer who was or is a "covered employee" for any tax year beginning after December 31, 2016. Further, the Section 162(m) proposed regulations issued by the IRS in December 2019 provide an elaborate framework for determining when a public company must treat an individual as a covered employee by virtue of the person having been a covered employee of a predecessor of the public company. The rules vary based on transaction context, but generally sweep quite broadly.

These changes increase the number of active employees who can be "covered employees" in a given year and eliminate a corporation's ability to deduct amounts in excess of $1 million paid following a covered employee's termination of employment. Accordingly, companies should be mindful that individuals who appear in the Summary Compensation Table in the annual proxy statement for one year will be "covered employees," effectively forever.

While companies wishing to minimize the impact of these changes could theoretically try to structure compensation so that there is limited turnover

in the Summary Compensation Table population, we expect that the importance of making commercially appropriate compensation decisions will outweigh such structuring considerations. Companies should, however, review their list of executive officers and eliminate any individuals whose job functions do not warrant such classification. Also, as the covered employee population is backward-looking and therefore continually expanding, companies should maintain a list of all covered employees and update it annually.

Note also that the extension of "covered employee" status beyond termination of employment could result in some companies favoring installment payments of deferred compensation and severance obligations over lump sum payments, in an effort to maximize the payments that fall below the $1 million limit in any given year. In most cases, however, we again expect that design and business considerations will trump tax structuring.

3. Continuation of Section 162(m) Compliance Procedures

In summary, prior to the 2017 Tax Reform Act, the $1 million deduction limit did not apply to compensation payable solely on account of attaining one or more pre-established, nondiscretionary and objective performance goals established no later than 90 days after the beginning of the service period to which the goal relates and within the first 25% of such period, so long as establishment of the goals was determined by a compensation committee (or a subcommittee thereof) of the board of directors composed solely of two or more "outside" directors within the meaning of Section 162(m), and at the end of the period and before the compensation was paid, such committee of "outside" directors certified that the performance goals and any other material terms had been satisfied.

Given the elimination of the performance-based compensation deduction, public companies that no longer maintain any "grandfathered" arrangements are not required to ensure that compensation committee members meet the requirements of "outside" directors under Section 162(m), and corresponding updates may be made to director and officer questionnaires, compensation committee charters, equity plan documents, and other arrangements that previously referenced the "outside" director requirements.

"Grandfathered" arrangements are, generally, written binding contracts in effect as of November 2, 2017, which are not materially modified (*i.e.*, amended to either increase compensation or accelerate the payment of compensation without a time-value discount) thereafter. On December 18, 2020, the IRS issued final regulations that construe narrowly the scope of

this "grandfathering" rule.[63] Under these final regulations, the IRS clarified that arrangements permitting but not requiring the exercise of negative discretion when a compensation committee determines a bonus, do not constitute grandfathered arrangements for purposes of the performance-based compensation deduction exception. As of 2022, any remaining "grandfathered" arrangements are likely stock options, which do not require a certification by "outside" directors.

B. Section 409A of the Internal Revenue Code

Section 409A of the Code ("Section 409A") imposes penalties on participants in deferred compensation arrangements that do not comply with the strict requirements of the rules published under Section 409A. "Deferred compensation" for these purposes can, perhaps unexpectedly, include severance payments and reimbursement rights. Given the far-reaching impact of Section 409A, companies have rightly devoted, and continue to devote, a great deal of time and resources to implementing and operating programs to comply with Section 409A. While a compensation committee should satisfy itself that the company is aware of and is complying with the legislation, the committee need not spend inordinate amounts of time trying to understand the intricacies of the technical rules that have no impact on the arrangements' commercial terms.

C. Stock Exchange Rules Regarding Shareholder Approval of Equity Compensation Plans

1. General Rules

NYSE and Nasdaq listing standards require listed companies to obtain shareholder approval of most equity compensation plans. A compensation committee should be aware that these rules may require shareholder approval of proposed plans and material plan amendments. NYSE and Nasdaq rules *exclude* the following types of plans from this shareholder approval requirement if all applicable requirements for the particular exclusion are met:

- arrangements under which employees receive cash payments based on the value of shares rather than actual shares (*e.g.*, cash-settled RSUs);

- arrangements that are made available to shareholders generally (such as a typical dividend reinvestment plan);

[63] Treasury Regulations Section 1.162-33, 26 C.F.R. § 1.162-33.

- arrangements that merely provide a convenient way for employees, directors or other service providers to purchase stock at fair market value;

- plans intended to qualify under Section 401(a) of the Code (qualified pension, profit-sharing and stock bonus plans) or Section 423 of the Code (employee stock purchase plans) (but note that shareholder approval for a Section 423 plan is separately required by the tax rules);

- "parallel excess plans," a narrowly defined category of excess benefit plans;

- equity grants made as a material inducement to an individual becoming an employee of the company or any of its subsidiaries;

- rollover of options and other equity awards in connection with a merger or acquisition; and

- post-acquisition grants to those who are not employees of the acquirer at the time of acquisition of shares remaining under a target plan that had been approved by the target's shareholders (although use of such share reserves in connection with the transaction will be counted by the NYSE and Nasdaq in determining whether the transaction must receive shareholder approval as an issuance of 20% or more of the company's outstanding common stock).

2. Material Revisions

The NYSE and Nasdaq rules provide the following examples of revisions to equity compensation plans that are considered "material" and therefore require shareholder approval:

- a material increase in the number of shares available under the plan, other than an increase solely to reflect a reorganization, stock split, merger, spin-off or similar transaction;

- an expansion of the types of awards available under the plan;

- a material expansion of the class of individuals eligible to participate in the plan;

- a material expansion of the term of the plan;

- a material change to the method of determining the strike price of options under the plan; and

- a deletion or limitation of any provision prohibiting repricing of options.

In light of the requirement that material amendments be approved by shareholders, a compensation committee should consider requesting that newly adopted plans be drafted to ensure maximum flexibility in the types of awards that can be granted and the terms and conditions thereof.

D. Dodd-Frank Act Compensation Clawback Rules

The Dodd-Frank Act requires that the SEC promulgate rules requiring NYSE- and Nasdaq-listed companies to adopt a policy mandating clawbacks of incentive compensation that was paid to a current or former executive officer during the three-year period preceding the date on which the company is required to prepare an accounting restatement as a result of material noncompliance with the securities laws, if the compensation is determined to have been based on erroneous data. The SEC is further required to direct the securities exchanges to prohibit the listing of companies that do not comply with those rules.

In November 2022, the SEC adopted final rules on the clawback of compensation as mandated under the Dodd-Frank Act.[64] The final Dodd-Frank Act compensation clawback rules are much broader than the only currently existing statutory clawback rule, which is the one provided under Section 304 of Sarbanes-Oxley. Most significantly, the Dodd-Frank Act clawback rules: (1) require each listed company to adopt a written recovery policy, whereas the Sarbanes-Oxley clawback operates on its own as a matter of law; (2) do not require there to have been any misconduct for compensation to be subject to clawback, as does Sarbanes-Oxley; and (3) cover all current and former executive officers of a listed company, whereas Sarbanes-Oxley only covers the CEO and CFO.

The final rules were published in the Federal Register on November 28, 2022 and became effective 60 days later on January 27, 2023. The securities exchanges must file proposed listing standards no later than 90 days following the publication date (*i.e.*, by February 26, 2023), and the listing standards must be effective no later than one year following the publication date (*i.e.*, by November 28, 2023). Issuers will have 60 days following the effective date of the applicable listing standards to adopt a compliant recovery policy. Failure to comply with these rules will result in delisting by the applicable exchange.

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[64] *See* Listing Standards for Recovery of Erroneously Awarded Compensation, 87 Fed. Reg. 73076 (Nov. 28, 2022) (amending 17 CFR pts. 229, 232, 240, 249, 270, and 274), available here.

Generally, the final rules answer the questions that should be considered when implementing a clawback policy:

- *Which companies are covered?* With limited exceptions, the rules apply broadly to all companies with listed securities, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and issuers of listed debt whose stock is not also listed.

- *Which individuals are covered?* The recovery policy must apply to a company's current and former executive officers who served in that capacity at any time during the applicable look-back period. The term "executive officer" is defined expansively to include the company's president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division or function and any other person (including executive officers of a parent or subsidiary) who performs similar policy-making functions for the company.

- *What types of restatements trigger application of the recovery policy?* A restatement due to material noncompliance with any financial reporting requirement under the securities laws triggers application of the recovery policy. The determination regarding materiality is based on facts and circumstances and existing judicial and administrative interpretations.

- *How is the applicable look-back period determined?* Incentive-based compensation *received* during the three completed fiscal years immediately preceding the date that a restatement is required to correct a material error is subject to the recovery policy. Incentive-based compensation is deemed *received* in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs before or after that period.

- *What types of incentive-based compensation are covered?* Under the final rules, "incentive-based compensation" means any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. "Financial reporting measures" include measures that are determined and presented in accordance with the accounting principles used in a company's financial statements, as well as a company's stock price and total shareholder return. Importantly, stock options and other equity awards that vest exclusively on the basis of service, without any performance condition, and bonus awards that are discretionary or based on subjective goals or goals unrelated to financial reporting measures, do

not constitute incentive-based compensation. Issuers should be mindful that board materials and proxy disclosures regarding pay programs could impact whether or not the applicable compensation is treated as incentive-based compensation for purposes of the final rules.

- *How is the recovery amount determined?* The recovery amount equals the amount, calculated on a *pre-tax* basis, of incentive-based compensation received in excess of what would have been paid to the executive officer upon a recalculation of such compensation based on the accounting restatement. For incentive-based compensation that is not subject to mathematical recalculation based on the information in an accounting restatement (*e.g.*, compensation based on stock price goals or total shareholder return), the recoverable amount must be determined based on a reasonable, documented estimate of the effect of the accounting restatement on the applicable measure.

  For equity awards that are incentive-based compensation, if the shares or options are still held at the time of recovery, then the recoverable amount is the number of shares or options received in excess of the number that should have been received after applying the restated financial reporting measure. If options have been exercised, but the underlying shares have not been sold, the recoverable amount is the number of shares underlying the excess options applying the restated financial measure. If shares have been sold, then the recoverable amount is the sale proceeds received by the executive officer with respect to the excess number of shares.

- *Does the board have discretion over whether to seek recovery?* Board discretion is limited. A company is required to recover compensation in compliance with its recovery policy, *except* to the extent that pursuit of recovery would be impracticable because it would (1) impose undue costs on the company, (2) violate home country law based on an opinion of counsel or (3) cause a broad-based retirement plan to fail to meet the tax-qualification requirements. Before concluding that pursuit is not feasible, the company must first make a reasonable attempt to recover the incentive-based compensation. Finally, a board is required to apply any recovery policy consistently to executive officers, and a company is prohibited from indemnifying any current or former executive officer for recovered compensation.

- *What additional disclosure requirements do the rules impose?* A listed U.S. company is required to file its recovery policy as an exhibit to its Form 10-K. In addition, the final rules require disclosure in the company's annual proxy statement of the following items, among others, if, during the prior fiscal year, either a triggering restatement occurred or any balance of excess incentive-based compensation was

outstanding: (1) the names of individuals from whom the company declined to seek recovery, and the reasons for declining to do so, and (2) the name of, and amount due from, each person from whom excess incentive-based compensation had been outstanding for 180 days or longer.

The additional proxy statement disclosures related to clawback policies apply immediately following the effective date of the applicable listing standards.

Over the past several years, prior to the adoption of the final SEC clawback rules, the prevalence of clawback policies increased dramatically, in part because many institutional investors have actively promoted the adoption of clawback policies.[65] According to a recent study, 99% of 200 large publicly traded companies have disclosed that they maintain clawback policies, although most policies are discretionary and not mandatory.[66] The study indicated that common clawback triggers include the following: ethical misconduct leading to a financial restatement (42% of policies); a financial restatement without a requirement of ethical misconduct (53%); ethical misconduct without a financial restatement (54%); violation of restrictive covenants, such as noncompetition, nonsolicitation, nondisclosure or nondisparagement obligations (25% of policies); reputational risk (20%); and failure to supervise (7% of policies).

For companies that have already adopted a clawback policy that is broader than the policy required by the final regulations, decisions will need to be made as to how to reconcile the existing policy with the newly mandated policy. Combining the two policies could lead to undesirable complications. In particular, most existing policies provide discretion to the compensation committee or board of directors as to whether to exercise the clawback, while the new regulations generally require the company to apply the clawback on a mandatory basis. Mandatory application is fundamentally inconsistent with the design of a broad discretionary policy, so a decision will need to be made as to whether to narrow the breadth of the existing policy, or, alternatively, to bifurcate the policy so that it includes both the mandatory clawback required by the final SEC rule and the optionality for the compensation committee or board of directors to continue to exercise discretion in determining whether to apply the existing clawback right. Other alternatives include maintaining two policies, or eliminating the existing policy altogether.

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[65] *See, e.g.*, *BlackRock Investment Stewardship*, *Proxy voting guidelines for U.S. securities* (Jan. 2023), available here.

[66] *See* Meridian Compensation Partners LLC, *2022 Corporate Governance & Incentive Design Survey* (Fall 2022), available here.

Time will tell which approaches gain favor as companies adapt to the new rule.

Clawbacks may provide a number of benefits to a company, including enhancing shareholder confidence in executive accountability, promoting the accuracy of financial statements and aligning risks and rewards. Of course, there are also countervailing considerations. If inappropriately designed, clawback policies can result in unfair treatment of executives and put pressure on compensation committee members to enforce the policies, even where directors do not believe that it is appropriate to do so.

E. Human Capital Disclosure

In August 2020, the SEC adopted certain amendments to rules on the disclosure of human capital, expanding the information required to be described in annual reports on Form 10-K filed on and after November 9, 2020. Although the human capital disclosure may not fall expressly under a compensation committee's authority or responsibility as expressed in its current charter, boards of directors should consider whether the compensation committee is best suited to provide oversight of this disclosure, given that the topics that tend to be included in the disclosure—*e.g.*, diversity and inclusion, employee benefit programs, retention and succession—often have some overlap or connection with matters that are otherwise within the compensation committee's purview, including the determination of performance goals for incentive compensation programs.

In short, the new disclosure rules require a company to discuss, to the extent material to an understanding of the company's business taken as a whole, the following: "the registrant's human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel)." Notably, the SEC did not define the term "human capital," choosing instead to defer to each company to determine the appropriate scope of disclosure in light of its "unique business, workforce, and facts and circumstances."[67]

In light of this disclosure standard, however, a compensation committee (particularly if such committee has been tasked with oversight of this disclosure) may wish to take the following steps as it makes decisions relating to the design of incentive compensation and other compensation programs: (1) consider whether human capital measures are already

[67] *See Modernization of Regulation S-K Items 101, 103, and 105*, Release Nos. 33-10825; 34-89670 [85 Fed. Reg. 63726] (Aug. 26, 2020), available here.

disclosed and are consistent with disclosed corporate goals; and (2) engage in a "bottom-up" approach to determine the relevant human capital factors, starting the discussion with business unit leaders and filtering their feedback through senior management. If the compensation committee is tasked with oversight of the human capital disclosure, in seeking to determine whether and how certain factors relating to human capital resources (*e.g.*, demographic data) and certain human capital measures and objectives should be included in the disclosure, then the compensation committee may wish to consider:

- whether selected factors, measures or objectives can be monitored and measured on a consistent basis year over year;
- how, on a long-term basis, the factors, measures or objectives could change or need to be modified;
- how the relevant factors, measures or objectives could impact incentive compensation programs; and
- how the public disclosure of the relevant factors, measures or objectives could be viewed by the company's various stakeholders.

As initial data points, based on a November 27, 2020 survey of the first 50 large-cap companies to file human capital disclosure in which the human capital disclosure was deemed "significant,"[68] the most common disclosure topics were: extensive headcount data; diversity and inclusion initiatives; employee development and training; competitive pay and benefits; safety measures; employee benefits; culture, values and ethics; employee engagement; tenure, promotions and turnover; recruitment; and succession planning. We emphasize, however, that this list is by no means a complete universe of possible topics, and is not broken down by industry or geography, which could of course result in different topics being disclosed. In addition, a March 2021 analysis of early disclosure choices (using as a sample the first 100 annual reports on Form 10-K filed by companies with $1 billion in market capitalization following the November 2020 rule revisions) found that most disclosure was boilerplate and infrequently provided quantitative metrics.[69] The study also found that companies used "exceedingly generic" language in the disclosures

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[68] *See* FW Cook, *10-K Filings Show a Variety of Approaches to the New Human Capital Resources Disclosure Rules* (Nov. 2020), available here.

[69] *Human Capital Disclosure: What Do Companies Say About Their 'Most Important Asset'?* (May 5, 2021). Rock Center for Corporate Governance at Stanford University, Working Paper Forthcoming, available here.

and failed to shed light on the strategic aspects of human capital management, such as talent recruitment, development and retention.

In light of these initial trends, in reviewing human capital disclosure, a compensation committee may want to give careful consideration to whether the disclosure specifically and directly addresses the most material human capital management issues currently facing the company, with the goal of avoiding overly lengthy, boilerplate disclosures.

VI.

Change in Control Compensation Arrangements

A. Addressing Executive Uncertainty in a Deal Environment

As institutions face industry consolidation amid regulatory, competitive and business model challenges, employees are understandably anxious about the future should their employer be acquired by or merge with another entity—whether in a friendly, distressed or hostile deal. To offset these pressures and to permit successful recruitment and retention of executives, many companies have adopted arrangements containing change in control provisions. These typically include change in control severance or employment agreements providing enhanced severance, acceleration of equity compensation awards and accelerated payment and/or vesting of deferred compensation in the event of a qualifying termination in connection with a change in control. A 2020 study of executive change in control arrangements by Meridian Compensation Partners noted that approximately 75% of the study group companies maintained some form of change in control arrangement providing for cash severance, and approximately 95% of the study group companies provided for the "double trigger" (*i.e.*, a change in control plus a qualifying termination of employment) acceleration of vesting of outstanding equity awards in connection with a change in control, or "single trigger" vesting on the change in control, in the event that the successor in the transaction elects not to assume the outstanding equity awards.[70]

Change in control severance and other arrangements are not intended to deter combinations; rather, by reducing the personal uncertainty and anxiety arising from a merger, such arrangements can help to assure full and impartial consideration of takeover proposals by a company's management and aid a company in attracting and retaining key executives. These arrangements, prevalent at U.S. public companies, are both legal and proper, and widely recognized as effective retention and recruiting devices. Potential merger partners will likely have similar arrangements and be familiar with them from prior transactions. The costs associated with change in control arrangements are expected costs and there is no evidence that appropriately structured arrangements impact shareholder value or are unacceptable to ISS, Glass Lewis or institutional shareholders generally.

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[70] *See* Meridian Compensation Partners, *2020 Study of Change-in-Control Arrangements, December 2020*, available here.

Compensation issues, such as the treatment of equity awards, severance protection and retention, continue to be of critical importance in transactions. Changes in compensation arrangements stemming from the influence of proxy advisors, including the trends of eliminating "golden parachute" excise tax gross-ups and single-trigger vesting, and the increasing prevalence of performance-based and deferred equity awards, require companies to understand and consider in careful detail the consequences and tax implications of a change in control. Attention must be paid to the applicable statutes and regulations to make sure that all tax and other technical concerns are understood and properly addressed in any arrangement. Severance and other change in control protections should be reevaluated periodically in light of the changes in a company's compensation programs from year to year. The importance of these arrangements, both the economics and procedural protections, was brought to light in the days following Elon Musk's acquisition of Twitter in late 2022, where it was reported that Mr. Musk took the position that certain senior executives were fired for "cause" and therefore would receive no termination payments and benefits.

B. Forms of Compensatory Arrangements

1. Change in Control Protections

Many companies have adopted change in control protections for senior management. Typically, these protections include change in control severance or employment agreements or, increasingly, severance protection plans. A change in control employment or severance protection agreement or plan often becomes effective only upon a change in control or in the event of a termination of employment in anticipation of a change in control. A standard form of agreement or plan usually provides for a two- or three-year term after the change in control during which time the status quo is preserved for the executive in terms of duties, responsibilities and employee benefits. In general, if the status quo is not preserved and the executive resigns or the executive's employment is terminated by the company, then the executive would be entitled to severance pay (typically, a multiple of base salary plus an annual bonus amount).

When implementing or reviewing a change in control arrangement, careful attention should be paid to the change in control triggering events. Getting the definition of "change in control" right is critical to the practical operation of change in control provisions, especially when it is uncertain whether a deal will be consummated in a timely manner (or possibly ever) due to regulatory, antitrust or other impediments to closing. Change in control definitions should not trigger upon an event prior to the closing of a deal, such as the signing, public announcement, or shareholder approval of a merger agreement. These provisions not only create risks if

a deal is not consummated, but also prevent the arrangements from fulfilling their intended purpose: to retain employees through the closing of a transaction. The events that give rise to a change in control should be objectively defined. Definitions that give a board of directors the ability to determine when an event does not constitute a change in control, while seemingly preserving flexibility, are likely to place the board in an untenable position both legally and practically. Deactivation provisions could also result in conflicts between the board and management at a particularly awkward and critical time.

Severance benefits are generally expressed as a multiple (*e.g.*, three times) of pay. Less typically, they correspond to the term of the agreement such that the amount of severance declines for each day that the executive remains employed under the agreement during the term. Ultimately, the amount of severance payable is most relevant, and is dependent upon both the multiple of pay and the definition of "pay," which is typically expressed as the sum of base salary and bonus (which is commonly defined as target bonus or the higher of target bonus and average actual bonuses over the three prior years). In the change in control context, severance is almost universally paid in a lump sum because of the concern that an acquirer may cease to continue installment payments.

Most change in control employment or severance protection agreements and plans also contain provisions addressing the so-called "golden parachute" excise tax applicable under Sections 280G and 4999 of the Code. The federal golden parachute tax rules subject "excess parachute payments" to a dual penalty: the imposition of a 20% excise tax upon the recipient and the nondeductibility of such payments for U.S. federal income tax purposes by the paying company. Excess parachute payments result if the aggregate payments received by a "disqualified individual" that are "contingent on a change in control" equal or exceed three times the individual's "base amount" (the average annual taxable compensation of the individual for the five years preceding the year in which the change in control occurs). In such case, the excess parachute payments are equal to the excess of (1) such aggregate change in control payments over (2) the employee's base amount. In other words, the excise tax and nondeductibility rules apply not just to the excess over three times the base amount, but, once triggered, apply to the whole amount in excess of the base amount.

Three approaches generally are taken to dealing with golden parachute tax penalties in change in control agreements and plans:

- payments that are contingent on a change in control can be "cut back" to one dollar below three times the base amount, so that no payments are considered parachute payments;

- payments that are contingent on a change in control can be cut back to one dollar below three times the base amount, but only if the result is to give the employee a larger after-tax return than if the payment were not cut back (a so-called "better net after-tax" cutback); or

- payments can be "grossed-up" so that the employee is in the same after-tax position as if there were no excise tax.

After an analysis of the amounts involved, many companies historically adopted a "gross-up" provision in order to ensure that the excise tax would not undo the intended goals of the arrangement. In addition, gross-ups often were provided in order to ensure fair and uniform treatment because the excise tax punishes recently promoted and newly hired employees more harshly than longer-term employees, penalizes employees who do not exercise options more than those who do, and punishes employees who elect to defer compensation more than those who do not. Moreover, changes in the design of compensation programs (*e.g.*, including longer vesting periods, cliff vesting as opposed to installments, and a greater portion of performance-based compensation and mandatory deferrals) have exacerbated the impact of Section 280G on executives. For example, as a result of the manner in which the regulations under Section 280G value performance-based compensation for purposes of determining the amount of the payments contingent on a change in control, the tax is more likely to apply to employees who receive change in control acceleration of performance-based compensation than it is to those who receive acceleration of time-based awards.

Unfortunately for the affected officers, the now near-universal view of proxy advisors, such as ISS, is that the adoption of golden parachute excise tax gross-ups in new, extended or materially modified agreements, or executive change in control plans, is a "problematic" pay practice that is likely to result in a negative recommendation on a say on pay vote or, where there is no say on pay vote, or where concerns expressed by ISS on a say on pay vote are not addressed in the following year, a "withhold-the-vote" recommendation for the compensation committee members or even the entire board of directors. Companies that have implemented golden parachute excise tax gross-ups in preexisting agreements and plans and have determined that such gross-ups are in the best interests of the company and its shareholders need not eliminate them to avoid scrutiny by ISS, as ISS generally will make its recommendations regarding the periodic "say on pay" vote (but not the "golden parachute say on pay" vote) taking into account only agreements and plans that are new, extended or materially amended. Those companies that wish to preserve such gross-ups should only amend the arrangements that contain the gross-ups with great care, as such amendments could de-grandfather the arrangements and result in ISS review. While an extension of an existing

agreement will trigger ISS review, the automatic renewal of an agreement with an "evergreen" provision (itself a feature that ISS does not consider a "best practice") generally will not be deemed an "extension" for that purpose.[71]

In light of ISS's position on golden parachute excise tax gross-ups, many companies have elected to implement "better net after-tax" cutbacks. As the deductibility of compensation at the senior executive level is already limited due to the changes to Section 162(m), the lost deduction has become less relevant. In the past few years, there has been a trend for target companies to implement excise tax gross-ups in connection with the negotiation of a particular change in control transaction, particularly in circumstances (*e.g.*, transaction price provides a very high premium to market price) where executives would be harshly impacted by the excise tax even after applying all available mitigation alternatives.

2. Stock-Based Compensation Plans

In addition to employment and severance protection agreements and plans, companies should review the status of their stock-based compensation plans for change in control provisions. Plans often contain provisions for acceleration of stock options, lapse of restrictions on restricted stock and deemed achievement of performance goals on performance stock awards upon a change in control ("single-trigger" vesting) or upon a qualifying termination of employment thereafter ("double-trigger" vesting). Stock plans also often provide an extended post-termination exercise period for stock options and SARs upon terminations of employment following a change in control (*e.g.*, the lesser of three years or the remainder of the original term). Since these provisions may result in parachute payments, plan amendments should be considered and implemented in the context of an overall review of change in control employment protections, and the associated costs should be analyzed in that context. While ISS encourages double-trigger change in control vesting, single-trigger vesting provisions in an equity plan will not automatically result in a negative recommendation for the equity plan—for instance, where a plan provides for single-trigger vesting only when an acquirer declines to assume the outstanding equity awards. However, equity plans that include both single-trigger vesting and a liberal "change in control" definition are likely to receive a negative recommendation.

For purposes of evaluating equity plans, ISS in recent years modified its equity plan scorecard regarding change in control vesting features, from awarding or withholding points based on the actual vesting treatment of

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[71] *See* Chapter VIII of this Guide for a more detailed discussion of say-on-pay votes and ISS and Glass Lewis.

equity awards on a change in control, to awarding points based on the quality of disclosure of change in control vesting provisions. Full points for this factor under the EPSC will be given if the plan discloses with specificity the change in control treatment of both time-vesting and performance-based vesting awards. If there is no change in control provision in the plan, or if the plan allows discretionary vesting, then zero points will be earned for this factor.

In designing employee stock plans, as well as other types of benefit and compensation plans, companies should be sensitive to the need to retain key personnel through the closing of a transaction to help ensure that the board of directors is delivering to the acquirer an intact management team.

Despite the terms of the stock plan and award agreements, the treatment of equity awards in a transaction is often a negotiated point between the parties. Most equity plans contain flexible adjustment provisions to accommodate treatment that deviates from the default change in control provisions, as long as the negotiated treatment is not adverse to the award holders.

3. Separation Plans

In addition to change in control employment and severance protection agreements with, and/or plans covering, senior executives, many public companies have adopted change in control separation plans for less senior executives, sometimes covering the entire workforce. These separation plans either formalize existing practices or provide enhanced severance in the event of a layoff occurring within a limited period (such as one or two years) after a change in control. These plans generally provide for cash severance payments determined on the basis of seniority/position, pay and years of service or some combination of these factors, although a minimum and a maximum number of weeks of pay is usually specified, and may provide continuation of benefits with the company paying all or a portion of the expense and outplacement services. Severance usually is payable following an involuntary termination without cause and sometimes due to a constructive termination, such as relocation, decrease in base salary or wages, or material diminution in duties.

Due to the large numbers of people involved, separation plans should be adopted after a careful review of the estimated costs, including an analysis of the potential impact of golden parachute excise tax and deductibility provisions of the Code on the payments and benefits provided under the plan. Further, companies should be sensitive to the fact that in an in-market merger involving facility closings or similar reductions in force on both sides, harmonizing the target and acquiror's severance policies may

make sense, so that similarly situated employees of the acquirer and target who are laid off are treated uniformly.

4. Deferred Compensation Plans

Due to the credit risk associated with the payment of deferred compensation and other unfunded nonqualified plan benefits, plans often provide for, or participants elect, an immediate lump-sum payment of the entire account balance upon a change in control. Any such election should be reviewed to ensure that it complies with Section 409A. The definition of "change in control" applicable to change in control distribution provisions in, or individual elections under, deferred compensation plans for employees and directors should be reviewed and understood prior to a transaction, since Section 409A imposes significant limitations on the ability to alter distribution provisions or elections after they are established. Although some companies may prefer the administrative ease of having only one change in control definition for all purposes, a change in control definition that mirrors the definition in Section 409A is not required for all change in control provisions in all compensation arrangements. In general, companies should use definitions that they believe indicate a true transfer of control of the company and should provide, only to the extent required by Section 409A, that the definition will be triggered if such event also constitutes a "change in control event" within the meaning of Section 409A.

5. Rabbi Trusts

A rabbi trust is a trust created for the purpose of setting aside assets that may be used to fund an employer's non-tax-qualified benefit obligations, such as traditional deferred compensation balances, although in a change in control situation, severance is sometimes also covered by the trust. In general, companies adopt rabbi trusts for two reasons: (1) to provide a way to set aside funds to meet future obligations to pay deferred compensation or unfunded retirement benefits; and (2) to reassure employees that the assets to pay their compensation will be available and in the hands of a neutral third party. The latter concern is generally the primary motivation in establishing rabbi trusts that are only required to be funded upon a change in control. If there is a genuine concern that an acquirer may refuse to pay certain benefits after a change in control, then a rabbi trust allows payments to be made by the trustee in accordance with procedures designed to protect the employees against unfair treatment by the acquirer. Because an acquirer, especially in a friendly transaction, is rarely reluctant to pay severance following a change in control where the entitlement is clear, the rabbi trust's effectiveness in ensuring payment is rarely tested.

It should also be noted that under the U.S. tax rules pursuant to which rabbi trusts are able to exist, funds deposited into rabbi trusts remain general assets of the company, subject to the claims of unsecured creditors of the company in the event of a bankruptcy.

Finally, before implementing a rabbi trust, especially one containing a provision that requires full funding or makes the trust irrevocable on a change in control or imminent change in control, the compensation committee should consider the types of liabilities being funded and the timeline for the payment of such obligations, the costs involved in funding and maintaining the trust, and the costs of using the trustee as paying agent/administrator for the payment of benefits that are funded through the trust upon a change in control. The funding obligation and related costs may be large in relation to the benefits to participants.

6. Retention Programs

A retention program is a helpful tool to ensure that the employees who are necessary to the completion of a transaction and the transition following closing are retained and incentivized to stay focused and committed. Retention is an issue for both the seller and the buyer, with the seller often most concerned about retaining key employees through closing and the buyer focused on the transition beyond the closing. The specific terms of the retention program, such as total amount and general payment timing and terms, are negotiated in connection with a transaction by the management teams. Individual awards are usually made during the period between signing and closing. The impact of the excise tax under Section 280G of the Code and the application of Section 409A should be understood and considered when developing retention programs and allocating awards thereunder. Companies should understand the disclosure obligations relating to the adoption of a retention program, which could require filing a current report on Form 8-K if senior executive officers are participating.

7. Considerations in Mergers of Equals

The characteristics of "mergers of equals" or "MOEs" generally include a no or low premium deal, with social issues (*e.g.*, headquarters, name of combined company), governance matters (*e.g.*, the composition of the board and its committees, the designation of the chairman or lead independent director) and CEO succession addressed in greater detail than in other transactions. The succession, compensation and benefits issues in an MOE are complex, requiring a careful analysis of the existing arrangements of both parties to the transaction, as well as the tax implications under Sections 280G and 409A of the Code. In recent MOEs, new agreements (employment, consulting or both) are almost

always entered into with the CEOs of each party to the transaction at the time the merger agreement is signed, with the view that establishing the ongoing executive leadership and any planned transitions are important aspects of the transaction. MOE parties usually seek a balanced and equitable approach to retention and compensation matters, recognizing that synergies are a critical aspect of most MOEs. As with most compensation and employee retention matters, there is not a one-size-fits-all approach.

VII.

Special Considerations Applicable to Financial Institutions

Executive compensation and broad-based incentive compensation matters at financial institutions continue to be sensitive subjects that are scrutinized by the media and shareholders, and the regulatory requirements and standards relating to the design and administration of compensation arrangements at financial institutions are complex. While much of the public attention has been focused on executive compensation that is deemed excessive in amount, there has also been a critical assessment of the interplay among compensation and governance policies, corporate risk-taking and short-termism.

At this time, it is not clear whether, and if so when, the Biden administration will prioritize finalizing and implementing the compensation-related regulations for financial institutions under Section 956 of the Dodd-Frank Act, last issued in 2016, but there is a greater possibility of this occurring than under the prior administration. Financial institutions should expect the continued focus of regulators on the structure of compensation throughout the organization. Large banking organizations are in regular dialogue with regulators regarding the implementation of supervisory expectations relating to compensation design, governance and controls. Outside of the United States, highly prescriptive EU regulations on incentive compensation, such as a cap on bonuses to bankers, has resulted in higher fixed compensation (generally through increased salary), as European financial institutions seek to remain competitive in retaining talent. Some EU financial institutions have applied the EU regulations to the compensation of key personnel operating at U.S. subsidiaries, resulting in compensation design that is not always aligned with that of similar U.S.-only peers.

In the pursuit of good corporate governance and risk management, and as strongly encouraged by regulatory guidance, design changes in compensation programs at financial institutions include longer deferral periods and vesting schedules—changes that result in ongoing and growing deferred compensation expenses, which at some point will need to be paid. Clawbacks remain a focus at large financial institutions and are a design change that has proven to have some teeth.

Set forth below is a brief summary of the final guidance on the safety and soundness of incentive compensation policies, the re-proposed final rule under Section 956 of the Dodd-Frank Act and the Federal Deposit Insurance Corporation's (the "FDIC") golden parachute limitations. This summary generally identifies where the compensation committee has a specific responsibility or obligation and notes the complexity of the

regulatory framework surrounding the compensation arrangements of financial professionals, which has resulted in increased responsibilities and challenges for compensation committee members at financial institutions.

A. Safety and Soundness Guidance

In June 2010, the bank regulatory agencies jointly issued final guidance for financial institutions on incentive compensation. All banking organizations are expected to evaluate incentive compensation and related risk management, control and governance processes, and to address deficiencies or processes inconsistent with safety and soundness. This evaluation is to be done with a view to the three core principles described in the guidance—that incentive compensation should:

- provide employees incentives that appropriately balance risk and reward;
- be compatible with effective controls and risk management; and
- be supported by strong corporate governance, including active and effective oversight by the board of directors.[72]

The third principle is of primary importance to compensation committee members of banking organizations. The guidelines emphasize governance and board-level oversight and provide that the board of directors of an organization is ultimately responsible for ensuring that the organization's incentive compensation arrangements ("ICAs") for all covered employees—not just senior executives—are appropriately balanced and do not jeopardize the safety and soundness of the organization. The guidance makes clear that the organization, composition and resources of the boards of directors of banking organizations should permit effective oversight of ICAs. In particular, the guidance requires that a compensation committee take the following actions with respect to a company's ICAs:

- actively oversee ICAs and directly approve ICAs for senior executives;
- monitor the performance, and regularly review the design and function, of ICAs; and

[72] As used in the proposed guidance, the term "board of directors" refers to the members of the board who have primary responsibility for overseeing the incentive compensation system of a banking organization and, for purposes of this discussion, it is assumed that the compensation committee serves this function.

- for banking organizations that are significant users of ICAs, review the arrangements on both a backward-looking and forward-looking basis.

The guidelines expressly call for the involvement of functions, such as compliance, internal audit and risk management in the incentive compensation process. It is, therefore, likely that both management and the compensation committee will need to evolve towards a more consultative and multidisciplinary approach, in particular during the adjustment period, as new compensation best practices evolve in response to the increased regulatory scrutiny on incentive compensation. The guidance also indicates that the compensation committee should have access to a level of expertise and experience in risk management and compensation practices in the financial services industry that is appropriate to the nature, scope and complexity of the organization's activities.

The restructuring of ICAs has been an iterative process. At this stage, compensation committee members of financial institutions should be ensuring that management is implementing the final guidance and considering it when evaluating proposed compensation arrangements. To date, favored design changes have included:

- decreasing incentive compensation payout opportunities to 125% or 150% of target opportunity (previously, 200% was common);

- deferring a portion of the payout of incentive compensation, both cash and long-term incentives, over at least three years to better understand the risk outcomes, with payment of the deferred amounts to be contingent on achieving performance-based measures; and

- increasing the portion of incentive compensation paid in equity-based instruments, such as performance and restricted shares, with stock options disfavored other than in limited amounts.

These design changes generally contract the upside opportunity and provide for *ex post* adjustments to address negative tail risk. In addition, regulators expect companies to have a framework for the exercise of discretion in compensation matters so that discretionary decisions may be audited, and to have recoupment and clawback provisions in place for all forms of incentive compensation. Financial institutions have succeeded in balancing regulatory expectations with the "pay-for-performance" demands of shareholders and the need to attract, retain and incentivize executives and key employees.

As the regulation of compensation arrangements at banking organizations increases, the duties of compensation committee members expand. It is

important for compensation committee members to understand these duties and ensure that the organization has adequate resources to respond to the requests of the various regulators and implement compliant compensation programs. The consequences of failing to meet the standards of the compensation guidelines are not insignificant, as the guidelines provide that supervisory findings on incentive compensation will be included in exam reports and incorporated into supervisory ratings. In addition, supervisory or enforcement action may be taken if incentive compensation or related controls, risk management or governance pose a risk to safety and soundness, and acceptable curative measures are not underway.

B. Section 956 of Dodd-Frank Act

Section 956 of the Dodd-Frank Act prohibits incentive-based compensation arrangements at "covered financial institutions" with assets of $1 billion or more that provide excessive compensation or could expose the institutions to inappropriate risks that could lead to a material financial loss, and requires such covered financial institutions to report their incentive-based compensation arrangements. In April 2016, federal regulators (including the Federal Reserve, the FDIC and the SEC) re-proposed a rule regarding incentive-based compensation under Section 956 of the Dodd-Frank Act that was far more proscriptive for large financial institutions than the original proposed rule. The 2016 proposed rule under Section 956 of the Dodd-Frank Act would supplement existing rules and guidance of the bank regulatory agencies, imposing additional standards and reporting obligations that overlap, but are not entirely consistent with, existing requirements. Financial institutions covered by the rule would be required to comply no later than the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register. Any incentive-based compensation plan with a performance period that begins before such date would not be required to comply with the requirements of the proposed rule.

The comment period for the 2016 proposed rule ended in July 2016 and there has been no further formal action with respect to the proposed rule by the regulators as of the date of this Guide. Large financial institutions have likely already incorporated much of the process and compensation design aspects of the proposed rule into their compensation programs, but the adoption of the proposed rule would require incremental changes, the necessity and benefits of which are unclear. Below is a summary of the 2016 proposed rule.

1. Covered Financial Institutions

The proposed rule applies to covered financial institutions that have $1 billion or more in average total consolidated assets. The definition of "covered financial institutions" includes depository institutions and their holding companies (including the U.S. operations of a foreign bank), broker-dealers registered under Section 15 of the Exchange Act, investment advisors under the Investment Advisors Act of 1940 (whether or not registered), credit unions, Fannie Mae, Freddie Mac and Federal Home Loan Banks. The methodology for determining total consolidated assets under the proposed rule varies depending upon the category of the institution and the applicable regulator, and for depository institutions that are not investment advisors, it is generally determined based on a rolling average.

The 2016 proposed rule introduced subcategories of covered financial institutions based on the amount of average total consolidated assets as follows: (1) Level 1 covered financial institutions would be covered financial institutions with average total consolidated assets of $250 billion or more and subsidiaries of such institutions that are themselves covered financial institutions; (2) Level 2 covered financial institutions would be covered financial institutions with average total consolidated assets of between $50 billion and $250 billion and subsidiaries of such institutions that are themselves covered financial institutions; and (3) Level 3 covered financial institutions would be covered financial institutions with average total consolidated assets of between $1 billion and $50 billion.

2. Covered Persons

The proposed rule applies to "covered persons," which include executive officers, employees, directors and principal shareholders. While all employees are potentially covered persons, the proposed rule is intended to apply to the incentive compensation arrangements for covered persons or groups of covered persons that could encourage inappropriate risk-taking to the detriment of the covered financial institution. The 2016 proposed rule also introduces additional limitations on the incentive compensation of "senior executive officers" and "significant risk-takers" of Level 1 and Level 2 covered financial institutions. The "executive officers" of a covered financial institution include any person who is a "senior executive officer" as defined in the proposed rule (*i.e.*, any person who holds the title or performs the function of one or more of the following positions: president, CEO, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer or head of a major business line or control function and other individuals designated as executive officers by

the covered financial institution). The proposed rule also provides guidance on who is considered a significant risk-taker, with the primary factor being whether the individual's incentive compensation is at least one-third of their total compensation.

3. Prohibitions under the Proposed Rule

Under the proposed rule, a covered financial institution would be prohibited from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by providing excessive compensation. "Incentive-based compensation arrangement" means any variable compensation arrangement that serves as an incentive for performance, including equity-based compensation. "Excessive compensation" means amounts that are unreasonable or disproportionate to the value of the services performed.

In evaluating whether compensation is excessive, the agencies will consider, among other factors, the following:

- the combined value of all compensation, fees or benefits provided to the covered person;
- the compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
- the financial condition of the covered financial institution;
- compensation practices at comparable institutions;
- for post-employment benefits, the projected total cost and benefit to the covered financial institution; and
- any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse with regard to the covered financial institution.

Accordingly, while the proposed rule would apply directly only to incentive-based compensation, regulators will consider all compensation and benefits arrangements in the evaluation of the incentive-based arrangements.

The proposed rule would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements that encourage a covered person to expose the institution to a material financial loss. To comply with this standard, an incentive-based compensation arrangement must balance risk and financial rewards (*e.g.*, through payment deferrals, risk adjustment of awards, and/or longer

performance periods), be compatible with effective risk management and controls and be supported by effective corporate governance, namely through board of directors' oversight of incentive-based compensation arrangements.

4. Additional Requirements Applicable to Level 1 and Level 2 Covered Financial Institutions

Level 1 and Level 2 covered financial institutions would also be subject to several additional, prescriptive requirements with respect to incentive-based compensation arrangements, including, among others:

- *Maximum Opportunities (i.e., Caps on Incentive-Based Compensation).* Level 1 and Level 2 covered financial institutions would not be permitted to award incentive-based compensation to senior executive officers and significant risk-takers in excess of 125% and 150%, respectively, of the target amount for the incentive-based compensation.

- *Relative Performance Measures.* Level 1 and Level 2 covered financial institutions would not be permitted to use incentive-based compensation performance measures that are solely based on industry peer performance comparisons.

- *Volume-Driven Measures.* Level 1 and Level 2 covered financial institutions would not be permitted to award incentive-based compensation to covered persons that is based solely on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management.

- *Minimum Deferral (Level 1).* Level 1 covered financial institutions would be required to defer a specified portion of the short- and long-term incentive-based compensation awarded to its senior executive officers and significant risk-takers (60% and 50% for senior executive officers and significant risk-takers, respectively) for each performance period for a minimum period of time (at least four years for short-term incentive compensation and at least two years for long-term incentive compensation). No more than 15% of a senior executive officer's or significant risk-taker's total incentive compensation awarded in stock options would count toward the deferral requirements.

- *Minimum Deferral (Level 2).* Level 2 covered financial institutions would be required to defer a specified portion of the short- and long-term incentive-based compensation awarded to its senior executive officers and significant risk-takers (50% and 40% for senior executive officers and significant risk-takers, respectively) for each performance

period for a minimum period of time (at least three years for short-term incentive compensation and at least one year for long-term incentive compensation). The same limitation on options as described above for Level 1 covered financial institutions would also apply to Level 2 covered financial institutions.

- *Vesting During the Deferral Period.* During the deferral period described above, incentive-based compensation may not vest faster than on a pro rata annual basis beginning on the first anniversary of the end of the performance period for which the amount was awarded, and the vesting of the deferred incentive-based compensation may not be accelerated other than in the case of the death or disability of the covered person.

- *Downward Adjustment.* Deferred incentive-based compensation awarded to Level 1 and Level 2 senior executive officers and significant risk-takers would need to be subject to "downward adjustment" (*i.e.*, forfeiture) if any of the following adverse outcomes occurred at the covered financial institution: (1) poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered financial institution's policies and procedures; (2) inappropriate risk-taking, regardless of the impact on financial performance; (3) material risk management or control failures; (4) noncompliance with statutory, regulatory or supervisory standards that results in enforcement or legal action against the covered financial institution brought by a federal or state regulator or agency or a requirement that the covered financial institution report a restatement of a financial statement to correct a material error; and (5) other aspects of conduct or poor performance as defined by the covered financial institution.

- *Clawback*. Incentive-based compensation awarded to Level 1 and Level 2 senior executive officers and significant risk-takers would be subject to a minimum seven-year clawback period following the date on which the compensation vests. Events triggering clawback include: (1) misconduct that resulted in significant financial or reputational harm to the covered financial institution; (2) fraud; or (3) intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation. It is not clear how this provision would interact with the SEC's final compensation clawback rules discussed above.

- *No Hedging.* Level 1 and Level 2 covered financial institutions would not be permitted to engage in transactions on behalf of covered persons to hedge or offset any decrease in the value of the covered person's incentive-based compensation.

5. Policies and Procedures

To help ensure compliance with the proposed rule, covered financial institutions would be required to implement policies and procedures with respect to incentive-based compensation, including recordkeeping obligations for all covered institutions to ensure the ability to disclose records relating to the incentive arrangements to their primary regulator upon request. The 2016 proposed rule also incorporates several additional requirements for Level 1 and Level 2 covered financial institutions with respect to oversight, risk management, controls, and governance policies and procedures, including, among others, (1) recordkeeping requirements that mandate that the covered financial institution maintain detailed records with respect to its incentive-based compensation arrangements for senior executives and significant risk-takers for at least seven years in a manner that allows for an independent audit; (2) requirements that the compensation committee obtain annual written assessments with respect to the institution's incentive-based compensation program from both management and an independent third party; and (3) a requirement to develop and adopt a risk-management framework for its incentive-based compensation program that is independent of any line of business and includes an independent compliance program for internal controls, testing, monitoring and training.

C. FDIC Golden Parachute Regulations

Payments to executives of "troubled" financial institutions may be limited under the "golden parachute" rules of the FDIC. Subject to certain exceptions, the FDIC rules prohibit troubled insured depository institutions (or their holding companies) from making golden parachute payments to any "institution-affiliated party" ("IAP"), which includes the institution's directors, officers and employees, among others. The FDIC rules generally define "golden parachute payments" as compensatory payments (or agreements to make compensatory payments) to an IAP by a troubled insured depository institution that are contingent on, or payable after, the termination of the IAP's primary employment or affiliation with the institution, with exceptions for certain *bona fide* deferred compensation payments, qualified retirement plan payments, limited payments under nondiscriminatory severance pay arrangements and payments under certain employee welfare benefit plans. An institution subject to the FDIC's golden parachute rules may, subject to obtaining the written consent of the appropriate federal banking agency, make parachute payments to IAPs under an agreement that provides for payment of a reasonable severance payment, not exceeding twelve months of salary, in the event of a change in control of the institution (other than an FDIC-assisted transaction or in connection with FDIC receivership or conservatorship).

VIII.

Shareholder Proposals, Relations and ESG Trends

Annual, mandatory say on pay shareholder advisory votes are for the most part an ordinary fact of life for public companies. Concern over say on pay support levels continues to influence company action, both in terms of compensation design and shareholder outreach strategy. This Chapter VIII discusses the evolution of say on pay, as well as other notable developments in the area of compensation-related shareholder proposals, the compensation policies of proxy advisory groups (notably, ISS) and executive compensation litigation.

A. Say on Pay

Since 2010, the Dodd-Frank Act has mandated three different types of nonbinding shareholder votes on compensation matters:

- No less frequently than once every three calendar years, each public company must submit the compensation of its NEOs to a nonbinding shareholder vote (the say on pay vote). Most public companies have opted for annual say on pay votes.

- No less frequently than once every six calendar years, each public company must submit for a nonbinding shareholder vote the question of whether the say on pay vote should be held annually, biennially or triennially (the say-when-on-pay vote). As discussed below, this vote occurred most recently in 2017 for most companies.

- In any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets, a public company must submit all golden parachute arrangements covering any of its NEOs to a separate nonbinding shareholder vote, (the "golden parachute say on pay" vote), unless the arrangements have already been "subject to" a say on pay vote.

1. The Say on Pay Vote

The say on pay vote must cover the compensation of a company's NEOs, as disclosed in accordance with Item 402 of Regulation S-K, including the CD&A; it does not cover director compensation, nor does it cover the portion of the proxy statement disclosure related to compensation and risk with respect to broad-based programs. The vote is a single line item on the relevant compensation arrangements in their entirety. The SEC rules do not require companies to use specific language or a prescribed format

in "say on pay" resolutions, although they include a nonexclusive example of a resolution that would satisfy the applicable requirements. The proxy statement must include an explanation of the effect of the vote (*i.e.*, that it is nonbinding), and future proxy statements must address whether (and if so, how) the company has considered the results of the most recent vote in determining compensation policies and decisions.

The say on pay vote serves as an important barometer of shareholder views of a public company's compensation practices. As discussed below, ISS has indicated that it utilizes say on pay votes, where offered, as its primary vehicle for expressing dissatisfaction with compensation practices. While the say on pay vote is nonbinding, companies are quite focused on receiving a favorable outcome, and poor results have the potential to trigger significant investor pressure and even litigation.

In 2022, over 96% of Russell 3000 companies that submitted a say on pay vote received majority support, with average support levels at approximately 89.2%, and with approximately 72% of such companies receiving more than 90% support. ISS recommended a vote against approximately 14% of Russell 3000 and 12.7% of S&P 500 company proposals (approximately 270 and 160 basis points higher, respectively, than the 2021 rates), so a favorable vote was achieved even in a significant majority of the cases where ISS had made a negative recommendation. However, an ISS negative recommendation correlated with lower support levels. Companies that received an ISS "against" recommendation achieved an average vote result of 32 percentage points lower, in the case of Russell 3000 companies, and 38 percentage points lower, in the case of S&P 500 companies, than companies that received a "for" recommendation.[73]

Despite generally positive year-over-year say on pay results, companies should approach each proxy season with a fresh perspective, as changes in company performance, company compensation programs, and investor guidelines can have significant impact. As discussed below, ISS engages in extra scrutiny of company responses to say on pay for those that did not achieve 70% support in the prior year's say on pay vote, and has indicated a willingness to more actively recommend withhold votes from members on compensation committees where there is a view that companies with low support are not sufficiently responsive to shareholder feedback received.

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[73] *See* Semler Brossy, *2022 Say on Pay & Proxy Results Report* (Jan. 12, 2023), available here.

Each company's situation is unique, but, generally, the steps a company can take that will best position the company for a positive say on pay vote remain fairly constant from year to year, and include the following:

- *Analyze Prior Year's Results and Monitor Shareholder Policies*. Companies should review the voting policies of major shareholders and understand the ways in which compensation practices may deviate from those policies. As part of that review, companies should revisit the prior year's vote results and proxy advisory firm recommendations in order to understand issues that may be particularly sensitive for the advisory firms and major shareholders. While companies should not make substantive compensation decisions that they do not believe are in the interests of long-term value increases to the company, merely in the hopes of increasing support for their say on pay proposals, changes may be appropriate where a company determines, upon reflection, that its compensation arrangements could be improved based on feedback from its shareholders and proxy advisors.

- *Communicate With Shareholders Through the CD&A*. The CD&A represents a critical communication tool in the effort to win say on pay votes. A company should use an executive summary to highlight key points and key developments since the prior year, shareholder-favored practices that the company maintains, and "hot button" practices that the company does not maintain. Given the large number of proxy statements that the typical institutional shareholder must review each proxy season, ease of readability is critical.

- *Directly Engage With Shareholders*. Whether or not a given company has received low support in the prior year, institutional investors and proxy advisors have come to expect companies—especially those that have reason to be concerned about low support at the next annual meeting (*e.g.*, its three-year TSR is low)—to be offering a direct dialogue not just immediately before ISS issues its report, but throughout the year, and before annual compensation goals and targets are set for an upcoming year. This is a process that requires careful consideration, and involves:

    - identifying significant shareholders that should be approached and, if available, their voting policies;

    - determining the person at each identified shareholder who should be contacted, with the goal being to gain the ear of a decision-maker and recognizing the delineation at most large institutions between the investment management team and the proxy voting team;

- deciding who should make the approach to the identified shareholders, understanding that some shareholders prefer to meet with compensation committee members (particularly, the chair), while others prefer meeting with in-house subject matter experts in the executive compensation, human resources or legal functions (but not the CEO, as the discussion is often about his or her own compensation) and outside advisors;

- figuring out the ideal time to approach the identified shareholders, with the understanding that telephone calls and meetings that occur outside of the proxy season are most likely to gain focused shareholder attention and also provide an opportunity for a second approach to the shareholders after the issuance of the ISS report if it is problematic; and

- crafting a section of the CD&A to describe the shareholder engagement process, including any changes in compensation programs based on shareholder feedback.

- *Respond to ISS's Recommendations*. As noted above and discussed below, ISS wields significant influence in the say on pay process.

  - ISS Corporate Solutions can be engaged, for a fee, to analyze, among other things, elements of equity plans being proposed for approval to shareholders, as well as compensation arrangements that may be up for approval in any say on pay advisory vote. The purpose of obtaining such a review in advance of a company filing its annual proxy is to allow companies to address any issues that ISS Corporate Solutions may identify as problematic, either through shareholder engagement, enhanced proxy disclosure, or both.

  - After the proxy statement has been filed, ISS will issue its report regarding the say on pay proposal. While in recent years ISS gave U.S. S&P 500 companies an opportunity to comment on ISS's report before it is finalized, ISS announced that effective January 2021, it will no longer continue this practice, although it will issue an "Alert" if it is notified of a factual error to update a previously issued proxy report. ISS has also advised that if "significant new information is publicly disclosed in a timely manner," ISS will issue an "Alert" only if (1) "warranted," as it determines it to be, and (2) if sufficient time is available before voting deadlines in that market for their institutional investor clients to review any changes in the Alert "(which <u>could</u> include a change to a previously issued vote recommendation)."

Although in prior years, ISS rarely changed its vote recommendations based on responses from companies after giving companies a chance to respond to preliminary reports, this reversal of practice emphasizes how critical an ongoing annual shareholder outreach program is. Along with clear and complete disclosure, ongoing shareholder outreach will assist a company in being able to quickly and directly solicit and obtain shareholder support of its compensation arrangements, despite a negative ISS say on pay recommendation.

2. The Say-When-on-Pay Vote

The Dodd-Frank Act requires a nonbinding vote, at least once every six calendar years, to determine the frequency of say on pay votes. SEC rules require that shareholders receive the option to vote for one of four choices (annual, biennial, triennial or abstain). Thus, a company cannot offer a "yes" or "no" vote on its preferred option, although the company may make a vote recommendation.[74] In 2011, when most companies were required to first conduct a frequency vote, the annual option received the most support at approximately 80% of companies, the triennial option received support at approximately 19% and the biennial option received support at approximately 1%. In response, over 70% of Russell 3000 companies elected to conduct votes annually. Since this time, the overwhelming majority of companies conduct votes annually, due in no small part to both ISS and Glass Lewis announcing that they will generally recommend in favor of an annual vote for companies submitting a say-when-on-pay vote to shareholders. In fact, ISS will recommend an "against" or "withhold" vote on the entire board if a company implements a say on pay vote on a less frequent basis than the frequency of timing that received the majority or plurality of votes cast at the most recent shareholders meeting. Given the six year cycle, most companies will need to submit to shareholders a proposal on say on pay frequency in the 2023 proxy season.

An annual say on pay vote offers many practical benefits. Providing shareholders with an annual say on pay vote gives shareholders an avenue other than director elections to express their dissatisfaction with pay practices at the company and, therefore, may save directors the embarrassment of receiving a significant number of "no" votes. In

[74] Note that, under SEC rules, companies may vote uninstructed proxy cards in accordance with management's recommendation for the frequency vote *only* if the company (1) includes a recommendation for the frequency vote in the proxy statement, (2) permits abstention on the proxy card, and (3) includes language in bold regarding how uninstructed shares will be voted on the proxy card.

addition, holding an annual say on pay vote may help the company avoid antagonizing shareholders that favor an annual vote.

One note on disclosure: a company must disclose in a current report on Form 8-K its decision regarding the frequency of the say on pay vote in light of the results of the say-when-on-pay vote. The Form 8-K must be filed no later than 150 calendar days after the date of the applicable meeting, and in any event no later than 60 calendar days prior to the deadline for submission of shareholder proposals for the subsequent annual meeting. Companies must include in their proxy materials disclosure of the current frequency of say on pay votes and when the next scheduled say on pay vote will occur.

3. The Golden Parachute Say on Pay Vote

Under the Dodd-Frank Act, the golden parachute say on pay vote applies to any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets.

SEC rules require disclosure in a prescribed tabular format of all golden parachute compensation arrangements in connection with any such transaction. For this purpose, SEC rules define "golden parachute" fairly broadly to encompass all agreements and understandings between the target or the acquirer and each NEO of the target or the acquirer that relate to the transaction. However, *bona fide* new employment arrangements with the acquirer often can be excluded. If a company previously has submitted golden parachute arrangements to a say on pay vote and has not modified those arrangements, then the company will not be required to submit those arrangements to the golden parachute say on pay vote, so long as the company's disclosure for the prior say on pay vote satisfied the tabular disclosure and other requirements applicable to golden parachute say on pay votes.[75] Notwithstanding this exception, in our experience it is unusual that a target company is able to rely solely on its disclosure for the prior say on pay vote, so companies should expect full disclosure of their executive officers' arrangements in the merger proxy statement.

ISS's current policy on these votes is to make recommendations on a case-by-case basis on proposals to approve golden parachute compensation, consistent with policies on problematic pay practices related to severance. ISS's golden parachute say on pay analysis includes an evaluation of a company's existing arrangements, as well as any new ones. ISS's views

[75] Note that the rules applicable to annual proxy disclosure of termination and change in control arrangements, unlike the golden parachute say-on-pay rules, do not prescribe a mandatory tabular disclosure format.

on equity vesting provisions when making recommendations in connection with a "say on golden parachute" vote remain unchanged in its most recent updated voting guidelines: (1) maintaining existing criteria is a "good practice"; (2) pro rata vesting based on actual goal achievement for performance awards and/or based on partial completion of the vesting period is a "best practice"; (3) acceleration of awards granted shortly before a change in control is viewed as a greater windfall; and (4) auto-acceleration concerns are greater when awards make up the majority of NEOs' golden parachutes, or where accelerated awards granted in the cycle before the change in control are larger than in prior cycles.

Beginning in 2021, Glass Lewis is taking a hard line regarding golden parachute gross-ups, deeming excise tax gross-ups unacceptable under "normal" circumstances. Below is the actual voting guideline:

> "Depending on the circumstances, the addition of new gross-ups around this excise tax particularly may lead to negative recommendations for a company's say-on-pay proposal, the chair of the compensation committee, or the entire committee, particularly in cases where a company had committed not to provide any such entitlements in the future. For situations in which the addition of new excise tax gross ups will be provided in connection with a specific change-in-control transaction, this policy may be applied to the say-on-pay proposal, the golden parachute proposal and recommendations related to the compensation committee for all involved corporate parties, as appropriate."

This last sentence should be a caution to acquiring companies, as historically, the boards of directors and their compensation committees have not been impacted by decisions of a target company's board of directors in connection with a transaction, though to date, we are not aware of any situations where this guideline has been applied to trigger any adverse voting recommendation in respect of the acquiring company's compensation committee.

Against this backdrop, target companies should be aware of the possibility of an ISS or Glass Lewis recommendation against the say on golden parachute vote in circumstances where transaction-based compensation arrangements implicate the items covered by the ISS and Glass Lewis guidelines as summarized above. Importantly, however, even if the recommendation against leads to a failed say on golden parachute advisory vote, the vote results from the last several years do not appear to indicate any correlation between levels of support on the golden parachute advisory votes and levels of support on approval of the underlying transactions.

B. Shareholder Proposals

In recent years, shareholder activists have increasingly chosen to push their agendas through shareholder proposals, including compensation-related shareholder proposals from institutional investors such as union pension funds and faith-based investors. Many of the proposals received during the last proxy seasons have been industry-specific and/or had an ESG focus, with more significant proposals relating to climate change, as well as pay equality and diversity. Of the ESG-related proposals made through September 2022, 177 were based on social issues, and 62 were based on environmental issues. These proposals received lower support in 2022: 9% of social proposals and 16% of environmental proposals received more than 50% support, whereas in 2021 18% of social proposals and 39% of environmental proposals received more than 50% support.[76]

The appropriate course of action with respect to any particular proposal will depend upon the facts and circumstances. In some cases, it may be possible to exclude a proposal under applicable SEC rules. A company and its legal counsel will need to thoughtfully consider the possible impact of excluding compensation-related proposals and weigh the pros and cons of engaging in a dialogue with the proponent to encourage the proponent to withdraw its proposal. In other instances, it may make sense to implement a particular proposal, whether in whole or in part.

In formulating responses to shareholder proposals, companies should recognize that activists and shareholder advisory firms carefully monitor company action in this area and may shine a spotlight on those companies that they view as uncooperative. Ultimately, however, executive compensation is a core responsibility of the board, and directors must bear in mind that they are best positioned to establish optimal company-specific compensation programs.

C. The Rise of ESG-Related Goals and the Future of Executive Compensation

In recent years, investors have increasingly focused on ESG issues—notably, climate change, DEI, and human capital management—and have called on companies to disclose their ESG performance and targets.[77] As a consequence, company boards are finding it necessary to become more deeply engaged in the oversight and integration of ESG issues in business

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[76] *See* Semler Brossy, *2022 Say on Pay & Proxy Results Report* (Sept. 29, 2022), available here.

[77] *See, e.g.*, World Economic Forum, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation* (January 2020).

strategy and the monitoring of their companies' progress towards ESG targets.

Increasingly, companies are demonstrating their commitment to their ESG goals by tying certain ESG metrics to executive compensation. A recent survey by FW Cook[78] of the 250 companies in the S&P 500 with the largest market cap found that, in 2022, 74% of these companies disclosed ESG metrics in their incentive plans (up from 64% in 2021). ESG use in incentive plans varied by industry and is most prevalent among companies in the energy, utilities, financials and health care sectors (with over 80% of surveyed companies tying ESG metrics to compensation), while it is least prevalent among companies in the consumer discretionary (65% prevalence). The types of ESG metrics employed also varied by industry: environment & sustainability metrics are most common among the energy and utilities sectors, while human capital and culture and DEI metrics were most common across other industries. This year saw a marked increase in the number of companies using diversity and inclusion metrics in incentive plans (58% in 2022 compared to 43% in 2021). Another recent study by Morgan Stanley[79] found that approximately 20% of the S&P 500 has tied short-term compensation to ESG goals. Among companies in the S&P 500 that link ESG to short-term compensation, around 70% disclosed some form of explicit weighting of ESG factors, with the average assigned weight being 17% of short-term incentive compensation.

Whether and how a company decides to address ESG in its compensation programs should be considered in the context of its broader ESG performance and the policies and processes it has in place to assure investors and other stakeholders of its commitment to carrying out its ESG ambitions, as well as the sector in which it operates, and evolving industry and market practices.

A preliminary analysis of considerations when tying compensation to ESG-related goals may include:

- which ESG issues are most relevant to the company, and whether key stakeholders agree on these priorities;

- determining whether the goals should be a stand-alone component of, a percentage of, or a basis to make an adjustment to, performance-based compensation;

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[78] *See* FW Cook's *2022 Use of Environmental, Social, and Governance Metrics in Incentive Plans* (Dec. 2022), available here.

[79] *See ESG-Linked Comp; Missing the Mark* (Jan. 2022) by Morgan Stanley Research.

- whether ESG metrics should feature in the company annual or long-term incentive plans;

- how progress on ESG issues will impact the company's financial bottom line over both the short term and long term (and whether this impact can be measured); and

- educating all constituencies regarding the relevance of the ESG issues and how the achievement of related goals benefits all stakeholders.

D. Shareholder Advisory Firms—Voting Guidelines

Over the last 10 years, the influence of shareholder advisory firms on executive compensation practices through their voting recommendations on executive compensation proposals cannot be overstated.[80] Below we discuss the influence firms like ISS and Glass Lewis have and continue to have on say on pay and equity plan proposals.

ISS—In General. The most influential of these firms is ISS. The compensation committee should regularly review updates regarding ISS's positions on pay practices, as a means of understanding the potential shareholder reaction to, and the best means of explaining, compensation decisions. We describe in Chapter VIII of this Guide some of ISS's positions on the say-when-on-pay and golden parachute say on pay advisory votes.

The say on pay vote is the primary vehicle, although not the only vehicle, through which ISS will express its view on a company's pay practices. As in prior years, in 2022 ISS will evaluate, on a case-by-case basis, its recommendation regarding say on pay proposals and compensation committee member elections where a company's say on pay proposal in the previous year received the support of less than 70% of the votes cast. ISS's evaluation will be based on the company's response to the concerns expressed by shareholders in the previous year, including disclosed engagement efforts with major institutional investors and specific actions taken to address the issues that led to the lack of support. ISS has stated that cases where support was less than 50% will "warrant the highest degree of responsiveness." Given the low threshold of opposition votes triggering the more stringent review, companies may treat a say on pay vote with majority, but less than 70%, support as effectively a lost vote.

The ISS U.S. compensation policy proxy voting guidelines effective for meetings on or after February 1, 2022 are not different in any material

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[80] *See* Chapter XI of this Guide for a discussion of ISS guidelines regarding non-employee director compensation.

respect to the guidelines issued for the prior proxy season.[81] ISS has advised the following regarding its recommendations:

- *If There is a Say on Pay Proposal on the Ballot*. ISS generally will recommend a vote against the proposal if (1) there is an unmitigated misalignment between CEO pay and company performance; (2) the company maintains significant problematic pay practices; or (3) the board exhibits a significant level of poor communication and responsiveness to shareholders.

- *"Withhold" and "Against" Vote Recommendations on Compensation Committee Members.* In general, ISS will recommend a vote against or withhold from the compensation committee members or potentially the full board if ISS believes (1) the board has failed to respond adequately to a previous say on pay proposal that received less than 70% of votes cast; (2) the company has recently practiced or approved problematic pay practices, such as option repricing or option backdating; or (3) "[t]he situation is egregious."

ISS—Problematic Pay Practices.[82] The list of problematic pay practices has remained relatively constant over the last few years. Pay elements that are not directly based on performance are evaluated on a case-by-case basis, including whether executive perquisites or benefits are a poor use of company assets, which could have a detrimental effect on the company. For this reason, companies should remain aware of, and remain current on, the list of problematic pay practices. That list is long, and includes:

- "egregious" employment contracts containing multi-year guarantees for salary increases, non-performance-based bonuses and equity compensation;

- an "overly generous" new hire package for a CEO (*i.e.*, sign-on awards that are excessively large or insufficiently performance-based, problematic termination-related equity vesting provisions or any other "problematic pay practices" listed in ISS's policy);

- "abnormally large" bonus payouts without justifiable performance linkage or proper disclosure (*e.g.*, performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance, or

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[81] *See ISS United States Proxy Voting Guidelines* (published Dec. 13, 2022), available here.

[82] *See ISS U.S. Compensation Policies Frequently Asked Questions* (Updated Dec. 16, 2022), available here.

payouts made despite failure to achieve pre-established threshold performance criteria);

- "egregious" pension or supplemental executive retirement plan payouts (*e.g.*, inclusion of additional years of service not worked that result in significant benefits provided in new arrangements, inclusion of performance-based equity awards in the pension calculation);

- "excessive" perquisites (*e.g.*, perquisites for former and/or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft or other "inappropriate" arrangements, extraordinary relocation benefits, including home loss buyouts or "excessive" amounts of perquisites compensation);

- "problematic" severance and/or change in control provisions (*e.g.*, (1) change in control cash payments exceeding three times base salary plus target/average/most recent bonus or that include equity gains or other pay elements in the calculation; (2) new or materially modified arrangements that provide payments without loss of job or substantial diminution of job duties, including upon certain voluntary terminations; (3) new or materially modified arrangements that provide for an excise tax gross-up; (4) "excessive" payments upon an executive's termination in connection with performance failure or payments in connection with apparent voluntary resignation or retirement; (5) liberal definition of "change in control" where no actual change in control has occurred; and (6) a "problematic" definition of "good reason" that presents windfall risks, such as definitions triggered by performance failures);

- tax reimbursements;

- dividends or dividend equivalents paid on unvested performance shares or units;

- internal pay disparity—*i.e.*, an "excessive differential" between total pay of the CEO and that of the next-highest paid NEO;

- repricing or replacing underwater stock options or stock appreciation rights without prior shareholder approval;

- significant shifts away from performance-based compensation to discretionary or fixed pay elements; and

- other pay practices that may be deemed problematic in a given circumstance, but are not covered in the above categories.

In addition, although not identified as a "problematic" pay practice, ISS has said that it is unlikely to support large, front-loaded equity award grants that are intended to cover more than four years (*i.e.*, the grant year plus three future years). ISS's concern is that such grants may limit the board's ability to meaningfully adjust future pay opportunities in the event of unforeseen events or changes in either performance or strategic focus. If a front-loaded grant is made, any commitments not to grant new equity awards in the period covered by a front-loaded grant should be firm.

It is also worth noting that there is an ISS FAQ expressly requiring a company to identify in disclosure the type of termination of employment, and the provision by which severance payments were made under the relevant plan or agreement, in lieu of the less clear disclosure that an executive has "stepped down" or that the executive and board "mutually agreed" on a departure.

Note that engagement in a small number of these practices may not, in itself, result in an adverse recommendation from ISS. However, there is a list of pay practices that ISS deems most likely to result in an adverse recommendation. The list of these particularly problematic practices includes:

- repricing (including through cash buyouts) underwater options/stock appreciation rights without prior shareholder approval;

- "extraordinary" perquisites or tax gross-ups, potentially including gross-ups related to restricted stock vesting and home loss buyouts, and any lifetime perquisites;

- new or extended agreements that provide for:

    - excessive change in control payments (*i.e.*, that exceed three times salary plus target/average/most recent bonus);

    - change in control severance payments that do not require an involuntary job loss or substantial diminution of duties, or in connection with a problematic definition of "good reason";

    - problematic definition of "good reason" that presents windfall risks, such as a definition triggered by potential performance failures;

    - change in control payments with excise tax gross-ups (including "modified" gross-ups);

    - multi-year guaranteed awards or increases that are not at risk due to rigorous performance conditions; and

- a liberal change in control definition combined with any single-trigger change in control benefits;

- insufficient executive compensation disclosure by externally-managed issuers ("EMIs") such that a reasonable assessment of pay programs and practices applicable to the EMI's executives is not possible;

- severance payments made when the termination is not clearly disclosed as involuntary (for example, a termination without cause or resignation for good reason); or

- any other provision or practice deemed egregious that presents a significant risk to investors.

As a reminder, ISS has advised that it will not consider a company's commitment to eliminate a problematic pay practice in the future as a way of preventing or reversing a negative vote recommendation.

ISS—Misalignment Between Pay and Performance. Given the importance of the pay-for-performance test and the focus by ISS on companies whose say on pay support falls below 70%, compensation committees will be well served by understanding this test, and may wish to consider having a "dry run" of it performed prior to proxy season in order to understand whether the vote might be at risk. Moreover, in the case of such a misalignment that is a result of a problematic equity compensation practice when there is an equity plan on the ballot, ISS may recommend voting against an equity plan proposal if it determines equity grant practices are driving the misalignment.

ISS has provided significant detail about how it runs its pay-for-performance test. If the results of a preliminary quantitative analysis indicate significant misalignment between CEO pay and shareholder returns and fundamental financial performance (both on an absolute basis and relative basis to a group of peers similar in size and industry), ISS will perform a more in-depth qualitative review of the programs.[83]

ISS – Equity Plan Proposals.[84] Under the ISS EPSC method of analyzing whether to recommend "For" or "Against" an equity plan proposal, recommendations on equity plan proposals are based on a combination of weighted factors related to: (1) plan costs based on a shareholder value

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[83] *See ISS U.S. Compensation Policies Frequently Asked Questions* (Updated Dec. 16, 2022), available here and *Pay-for-Performance Mechanics ISS' Quantitative and Qualitative Approach* (published Jan. 13, 2023), available here.

[84] *See ISS U.S. Equity Compensation Plans Frequently Asked Questions* (Updated Jan. 30, 2023), available here.

transfer measurement; (2) plan features, such as share recycling and change in control equity award treatment; and (3) company grant practices, including a three-year average burn rate relative to peers, the proportion of CEO's equity awards subject to performance conditions, as well as clawback and holding requirements, with weighting by categories of companies. A score of 57 or higher (out of 100 points) for an S&P 500 company, 55 or higher for a Russell 3000 company and 53 or higher for other companies is required to receive a favorable recommendation. In order for a company to receive points for a clawback policy, the policy should authorize recovery upon a financial restatement and cover all or most equity-based compensation for all NEOs. A company will not receive credit if the policy contains only the limited requirements under Sarbanes-Oxley, or if the company has disclosed that it plans to establish a policy after the finalization of applicable rules under the Dodd-Frank Act.

The current ISS list of "egregious" features that may result in an "Against" recommendation on any equity plan proposal, regardless of any EPSC score, is composed of the following items:

- a liberal change in control definition that could result in vesting of equity awards by any trigger other than a full double-trigger;

- repricing or cash (or stock award) buyouts of underwater options or SARs without shareholder approval;

- the plan is a vehicle for problematic pay practices or pay-for-performance misalignment;

- the plan is estimated to be excessively dilutive to shareholders' holdings (*i.e.*, the company's equity compensation program is estimated to dilute shareholders' holdings by more than 20% (for S&P 500 companies) or 25% (for Russell 3000 companies)); or

- any other plan features or practices that are deemed detrimental to shareholders (*e.g.*, tax gross-ups on equity awards).

Director Equity Compensation Plans.[85] In response to the increased scrutiny of director compensation arrangements in recent years, ISS has added guidance regarding evaluations of director equity plans. Initially, ISS had clarified that stand-alone director equity compensation plans would not be evaluated under the EPSC or taken into account for purposes of determining the company's three-year burn rate for its employee equity

[85] *See ISS U.S. Compensation Policies Frequently Asked Questions* (Updated Dec. 16, 2022), available here and *ISS U.S. Equity Compensation Plans Frequently Asked Questions* (Updated Jan. 30, 2023), available here.

compensation plans, unless the amount of director equity grants is larger than employee equity grants.

The current guidance regarding factors considered in ISS's qualitative review of director equity plan approval, when a stand-alone director equity plan exceeds the plan cost or burn rate benchmark, provides that in its review, ISS will examine:

- the relative magnitude of director compensation as compared to companies with a similar profile;
- the presence of problematic pay practices relating to director compensation;
- the director stock ownership guidelines and holding requirements;
- the equity award vesting schedules;
- the mix of cash and equity-based compensation;
- the meaningful limits on director compensation;
- the availability of retirement benefits or perquisites; and
- the quality of disclosure surrounding director compensation.

ISS has also modified its policy regarding advisory shareholder votes to ratify non-employee director compensation to eliminate the specific list of factors it reviews (although they were similar to the factors used to review a stand-alone director equity plan, above). Instead, in evaluating director pay plans, ISS will consider pay composition, magnitude and other qualitative features, such as "meaningful" director stock ownership requirements (*i.e.*, at least four times annual cash retainer). ISS also views performance-vesting equity awards, retirement benefits and other perquisites as problematic pay practices for non-employee directors. Moreover, ISS views a "meaningful limit" on annual director pay as a "positive" feature.

Glass Lewis. Glass Lewis continues to apply a "highly nuanced approach" in analyzing say on pay advisory votes, reviewing such vote proposals on a case-by-case basis, both on a qualitative and quantitative basis, and may recommend against a say on pay vote if, generally, the company fails to demonstrably link compensation with performance (*i.e.*, if there are deficiencies in a company's compensation program's design, implementation or management). Glass Lewis grades each company's pay-for-performance on a school letter system (A, B, C, D or F), noting

that a "C" in the Glass Lewis system indicates that the "company's percentile rank for pay is approximately aligned with its percentile rank for performance." Unlike ISS, Glass Lewis does not specifically disclose its methodology for weighting and scoring the factors used in its analysis.

Although not an exhaustive list, Glass Lewis may recommend voting "Against" a say on pay vote when the following issues are weighted together:

- inappropriate or outsized self-selected peer group and/or benchmarking issues, such as compensation targets set well above the median without adequate justification;
- "egregious or excessive" bonuses, equity awards or severance payments, including golden handshakes and golden parachutes;
- insufficient response to low shareholder support;
- problematic contractual payments, such as guaranteed bonuses;
- insufficiently challenging performance targets and/or high potential payout opportunities;
- performance targets lowered without justification;
- discretionary bonuses paid when short-term or long-term incentive plan targets were not met;
- executive pay that is high relative to peers and not justified by outstanding company performance; and
- "inappropriate" terms of the long-term incentive plans (as described in more detail in the voting guidelines).[86]

Additionally, Glass Lewis has noted that the following may "help to drive" a negative recommendation on a company's say on pay:

- excessively broad change in control triggers;
- inappropriate severance entitlements;
- inadequately explained or excessive sign-on arrangements;
- guaranteed bonuses (especially as a multiyear occurrence); and

[86] *See Glass Lewis, 2023 Policy Guidelines (United States)*, available here.

- failure to address any concerning practices in amended employment agreements.

Beginning in 2023, Glass Lewis has revised the threshold for the minimum percentage of the long-term incentive grant that should be performance based from 33% to 50%, and will raise concerns with executive pay programs where less than half of an executive's long-term incentive awards are subject to performance-based vesting conditions.

If a company receives 20% or greater shareholder opposition to a say on pay vote, Glass Lewis expects the board of directors to engage with its shareholders actively and respond to shareholder concerns, which may include implementing changes to its executive compensation program that directly address those concerns. In the absence of any evidence that the board is actively engaging shareholders on these issues and responding accordingly, Glass Lewis may recommend "holding compensation committee members accountable" for the failure to so respond, subject to the level of shareholder objection, severity and history of the company's compensation program.

Finally, in reviewing equity plan proposals, Glass Lewis utilizes a quantitative analysis to assess the plan's cost and the company's pace of granting equity awards, comparing plan limits relative to the peer group as chosen by Glass Lewis and taking into account dilution and projected annual cost relative to the company's financial performance and plans of peer companies, as well as comparing the plan cost against the company's operating metrics to determine whether the plan is excessive in light of company performance. Glass Lewis also utilizes a qualitative analysis, including plan and grant features and terms, and performance metrics, with a list of elements evaluated that are similar to those listed by ISS. Note also that Glass Lewis does not consider the CEO pay ratio a determinative factor in its voting recommendations.

Glass Lewis, like ISS, has also included a policy statement regarding director compensation, indicating that while it is generally supportive of competitive fees, excessive fees potentially compromise the independence of non-employee directors, and performance-based equity grants should not be granted to directors.

Conclusions. We recommend that compensation committees remain cognizant of the advisory firms' current policies and take them into account in structuring pay programs. However, because of the "one-size-fits-all" nature of their evaluation processes, in the final analysis, a compensation committee should make decisions that comport with its company's individual circumstances and needs.

E. The Rise of Institutional Investor Voting Guidelines

In recent years, we have seen institutional investors themselves issuing proxy voting guidelines, in response to both criticism of over-reliance on shareholder advisory firms and a shift to more targeted purpose-driven investing. Below is a brief description of the topics covered by a few of the largest asset managers active in the U.S. market.

BlackRock Investment Stewardship Proxy Voting Guidelines.[87] BlackRock's guidelines for U.S. companies identifies, among other things, how BlackRock evaluates executive compensation arrangements when considering a say on pay vote, covering topics and positions similar to those of ISS. BlackRock's commentary on executive compensation leans heavily towards early and often engagement by a company's compensation committee. Note that BlackRock may choose to vote against members of a compensation committee if any of the following determinations are made:

- there is a misalignment over time between target pay and/or realizable compensation and company performance as reflected in financial and operational performance and/or shareholder returns;

- the company has not persuasively demonstrated the connection between strategy, long-term shareholder value creation and incentive plan design;

- compensation is excessive relative to peers without appropriate rationale or explanation, including the appropriateness of the company's selected peers;

- there is an overreliance on discretion or extraordinary pay decisions to reward executives without clearly demonstrating how these decisions are aligned with shareholders' interests;

- company disclosure is insufficient to undertake BlackRock's pay analysis; and/or

- there is a lack of board responsiveness to significant investor concerns on executive compensation issues.

Note that BlackRock will also consider voting against members of a compensation committee during a period in which executive compensation

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[87] *See BlackRock Investment Stewardship, Proxy voting guidelines for U.S. securities* (Jan. 2023), available here and *Investment Stewardship's approach to executive compensation* (Jan. 2020), available here.

appears excessive relative to performance and peers, when BlackRock believes either that the compensation committee has not already substantially addressed this issue, or when engagement with the compensation committee regarding a particular say on pay proposal is not expected to resolve BlackRock's concerns.

Vanguard.[88] Vanguard takes a principles-based approach to evaluating its portfolio of investments, with one of its four "Pillars" being its perspective on executive compensation, which is as follows:

> "We believe that performance-linked executive pay (compensation or remuneration) policies and practices are fundamental drivers of sustainable, long-term value. We look for pay plans that incentivize outperformance versus industry peers over the long term."[89]

Vanguard also advises that it does not take a "one size fits all" approach to executive compensation, but does identify the following "red flags" when evaluating a say on pay proposal:

- pay outcomes are significantly higher than those of peers but total shareholder return is well below that of peers;
- the long-term plan makes up less than 50% of total pay;
- the long-term plan has a performance period of less than three years;
- plan targets are reset, retested, or not rigorous; and
- the target for total pay is set above the peer-group median.

A Vanguard fund will also generally vote against compensation committee members when: (a) it has voted against the company's say on pay proposal in consecutive years, unless meaningful improvements have been made to executive compensation practices since the prior year; and/or (b) voting against an equity compensation plan that includes significantly problematic features (*e.g.*, "repricing," "evergreen," "reload," or similar features) or other egregious pay practices exist.

Fidelity.[90] Fidelity has advised that it will generally support say on pay votes, *unless* the compensation appears misaligned with

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[88] *See Vanguard Proxy voting policy for U.S. portfolio companies* (Effective Feb. 1, 2023), available here.

[89] *Vanguard Global investment stewardship principles* (Nov. 2021), available here.

[90] *See Fidelity Investments Proxy Voting Guidelines* (February 2022), available here.

shareholder interests or is otherwise problematic, taking into account the following:

- the actions taken by the board or compensation committee in the previous year, including whether the company re-priced or exchanged outstanding stock options without shareholder approval; adopted or extended a "golden parachute"[91] without shareholder approval; or adequately addressed concerns communicated by Fidelity in the process of discussing executive compensation;

- the alignment of executive compensation and company performance relative to peers; and

- the structure of the compensation program, including factors such as whether incentive plan metrics are appropriate, rigorous and transparent; whether the long-term element of the compensation program is evaluated over at least a three-year period; the sensitivity of pay to below median performance; the amount and nature of non-performance-based compensation; the justification and rationale behind paying discretionary bonuses; the use of stock ownership guidelines and amount of executive stock ownership; and how well elements of compensation are disclosed.

Fidelity will also oppose the election of directors on the compensation committees if: (a) the company has not adequately addressed concerns communicated by Fidelity in the process of discussing executive compensation; (b) within the last year, and without shareholder approval, a company's board of directors or compensation committee has either: (1) repriced outstanding options, exchanged outstanding options for equity, or tendered cash for outstanding options, or (2) adopted or extended a golden parachute. Fidelity generally will oppose proposals to ratify golden parachutes where the arrangement includes an excise tax gross-up provision; single trigger for cash incentives; or may result in a lump sum payment of cash and acceleration of equity that may total more than three times annual compensation (salary and bonus) in the event of a termination following a change in control.

Conclusion: The principles and concerns stated in the foregoing asset management proxy voting guidelines are generally consistent with the guidelines issued by other large institutional investors. Compensation committees may be well-served by having an understanding of the proxy voting guidelines regarding say on pay and other compensation-related proposals of their top 10 institutional investors, if available, when

[91] Note that Fidelity defines a "golden parachute" as "executive severance compensation and benefit arrangements resulting from a termination following a change in control."

considering actions to be taken on such topics, as these guidelines represent long-term investors' views on how executive compensation programs should be structured to encourage and support long-term value creation at the companies in which they invest.

IX.

Compensation Committee Meetings

A. Meetings and Agenda

A compensation committee must meet with sufficient frequency to perform its duties, and should devote adequate time for planning the timing, agenda and attendees at its meetings. A compensation committee should schedule at least one of its meetings before the company's annual report and proxy statement are filed to provide an opportunity for the compensation committee to review and discuss the proposed CD&A and other compensation-related disclosures. The number of meetings a compensation committee should hold per year depends upon various factors, including the scope of the compensation committee's responsibilities, the size and business of the company, and the nature of the compensation arrangements implemented (or to be implemented) by the company. The SEC requires that companies disclose the number of compensation committee meetings held during the prior fiscal year in their annual proxy statements. Compensation committee meetings, like board of director meetings, should be sufficiently long to allot adequate time to carry out the duties of the compensation committee. Compensation committees should consider scheduling their meetings for the day before full board of director meetings to permit adequate time to consider and discuss agenda items.

A compensation committee should set aside sufficient time, without the presence of the CEO or other executive officers, to deliberate and determine the officers' compensation levels. For Nasdaq companies, the CEO may not be present during discussions of his or her compensation, but a similar requirement is not imposed for other executive officers. A compensation committee should have access to management as it deems appropriate.

A compensation committee should be active in setting its agendas for the year as well as for each compensation committee meeting. While management, rather than the board of directors, sets the strategic and business agendas for the company, including regulatory and compliance goals, directors should determine the bounds of their oversight and responsibilities. The compensation committee meetings and annual agendas should reflect an appropriate division of labor and should be distributed to the compensation committee members in advance. In light of the increased number of lawsuits regarding compensation matters, compensation committees should also ensure they receive materials regarding proposed compensation action in advance of their meetings, to provide the committee members sufficient time to review the materials.

B. Quorum Requirements

For a compensation committee to conduct official business at a compensation committee meeting, a quorum of its members must be legally present. Unless otherwise restricted in a company's charter, most states consider a director who participates via telephone or video conference to be legally present (as long as all those present at the compensation meeting can hear and speak to each other). A company's bylaws or a board of directors' resolution should set the minimum number of compensation committee members necessary to establish a quorum. If no minimum number is set by a company, then, absent a state law to the contrary, the default minimum quorum requirement for a compensation committee is a majority of its members. Similarly, the default quorum of the entire board of directors generally is a majority of its members. These principles flow from the general default rule that a committee of the board of directors is subject to the same corporate process requirements applicable to the entire board of directors.[92]

Neither the SEC nor the major securities markets have specific guidelines in this regard, although the SEC does require that the proxy statement disclose the number of compensation committee meetings held during the prior fiscal year, as well as the name of any director who attended fewer than 75% of the aggregate number of meetings of the full board of directors and the committees on which such director served.

Actions undertaken by a compensation committee in the absence of a quorum are voidable. Thus, the minutes should clearly reflect the presence of a quorum to protect valid decisions from attack. To help ensure that a quorum is present: (1) compensation committee meeting notices should be sent sufficiently in advance of a compensation committee meeting and responses promptly reviewed, and (2) the chairperson of the compensation committee should consult with the corporate secretary in advance of the compensation committee meeting. If a compensation committee meeting takes place without a quorum, it should be noted in the minutes.

C. Minutes

Typically, minutes are prepared for compensation committee meetings, but not for a compensation committee's executive sessions. It is common and prudent practice for such minutes to identify the topics discussed at compensation committee meetings rather than attempt to include detailed summaries. Enough information should be recorded, however, to establish

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[92] *See, e.g.*, § 8.25(c) of the Model Business Corporation Act (2016 Revision) (Dec. 9, 2017).

that the compensation committee sought the information it deemed relevant, reviewed the information it received, understood each element of the compensation and otherwise engaged in whatever actions and discussions it deemed appropriate in light of the then-known facts and circumstances. The minutes also should indicate which directors attended, whether they attended in person or via telephone or video conference and whether individuals other than the compensation committee members were present.

A compensation committee should approve the minutes at the next compensation committee meeting following the meeting for which the minutes were prepared. The minutes should be attached to the agenda for such meeting and circulated in advance so that the compensation committee members have time to review them before they are approved. If the minutes have not been attached and adequately reviewed before the next compensation committee meeting, it may be advisable for the corporate secretary to read the minutes to the committee members before approval to ensure that they are aware of the actions that were taken at the last compensation committee meeting and approve of their characterization in the minutes. Unless otherwise required by state statute or a company's charter or bylaws, it is neither necessary for the minutes to identify the director presenting a motion or resolution nor to separately identify the directors voting for or against a motion or resolution. However, a dissenting or abstaining director should be identified if he or she so requests.

A compensation committee should consider providing a report or a copy of the minutes of each compensation committee meeting to the full board of directors. Directors who do not serve on the compensation committee should have the opportunity to ask the compensation committee questions relating to the compensation committee's charter or the topics covered at the compensation committee meetings.

D. Shareholder and Director Right of Inspection

Careful drafting of minutes is especially important because shareholders may inspect the books and records of the company, including committee meeting minutes. In Delaware, for instance, any shareholder may inspect board of director and committee minutes upon making a written demand under oath and stating a "proper purpose" for making the request. While the proper purpose requirement ensures that shareholders do not have *carte blanche*, activist shareholders are increasingly using this right, and a court's willingness to entertain such a demand cannot be foreclosed.[93]

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[93] At least one Delaware Court of Chancery decision, *Polygon Global Opportunities Master Fund* v. *West Corp*., 2006 WL 2947486 (Del. Ch. Oct. 12, 2006), did announce

The Delaware Court of Chancery opinion in *Amalgamated Bank* v. *Yahoo! Inc.*,[94] discussed above in Chapter III of this Guide, demonstrates the utility of books and records demands in compensation-related claims. A 2005 Delaware Supreme Court order,[95] remanding a lower court decision allowing a company to demand confidential treatment before divulging sensitive information to dissident shareholders, illustrates the scrutiny companies may face when attempting to prevent public disclosure of even ostensibly confidential information. In its order, the Delaware Supreme Court held that the Court of Chancery must balance a company's interest in confidentiality against a shareholder's communication interest and establish that the confidentiality interest "outweigh[s]" the shareholder's interest.

In litigation, minutes carry added significance, given that both Delaware and New York accord corporate minutes a presumption of accuracy. Minutes have been cited in a number of high-profile cases as evidence of directors' alleged lack of care and/or good faith in exercising their fiduciary duties. It is especially important that minutes are carefully and thoughtfully drafted so that an ambiguous litigation record is not created. Courts and regulators reviewing a committee's actions often regard minutes as the most reliable contemporaneous evidence of what transpired at a meeting. In litigation concerning director-level conduct and decision-making, board and committee minutes are regularly used as evidence and can provide a guide to opposing counsel as to which directors to depose and what topics to cover in such depositions. It is therefore of vital importance that minutes be thoughtfully drafted to reflect the topics discussed at meetings and the substance of the committee's discussion.[96]

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several important limitations on the use of this tool in the transactional context and possibly beyond. In *West Corp*., an activist hedge fund (Polygon Global Opportunities Master Fund) demanded access to West Corporation's books and records after West Corporation announced its intention to undertake a going-private transaction. In denying Polygon Global Opportunities Master Fund's demand, the court held that, in certain circumstances, public information may be sufficient for the shareholder's stated purpose, the books-and-records statute "is not intended to supplant or circumvent discovery proceedings, nor should it be used to obtain that discovery in advance of the appraisal action itself" and Polygon Global Opportunities Master Fund's desire to investigate alleged board of director misconduct cannot be a proper purpose because Polygon Global Opportunities Master Fund would not have standing to pursue any claims (given that it purchased shares in West Corp. only after the announcement of the transaction). *Id.* at 16.

[94] *Amalgamated Bank, Trustee for the Longview LargeCap 500 Index Fund and the LongView LargeCap 500 Index VEBA Fund* v. *YAHOO! Inc.*, 132 A.3d 752 (Del. Ch. Feb. 2, 2016).

[95] *Disney* v. *Walt Disney Co.*, No. 380, 2004 (Del. Mar. 31, 2005) (ORDER).

[96] The need to document board actions with care was brought into sharp focus by the Delaware Supreme Court's ruling in *KT4 Partners LLC* v. *Palantir Techs. Inc.*, No. 281,

E. Access to Outside Advisors

Under stock exchange listing standards established pursuant to the Dodd-Frank Act, the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other advisor (after considering factors described in Chapter II of this Guide). The rules require compensation committees to be directly responsible for the appointment, compensation and oversight of the advisors they retain and the company to provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the advisors. Additionally, the charter of a compensation committee must address these rights and responsibilities. As noted above, disclosure requirements mandate detailed disclosure of fees and services in respect of consultants who are not independent.

Notwithstanding this heavy emphasis on consultant independence, retention of separate advisors for each of the compensation committee and management when considering issues of executive compensation may not always serve the company's best interests. Such an approach can give rise to inefficiencies in compensation discussions, put a board of directors in the awkward position of receiving conflicting advice, and, perhaps most importantly, create an adversarial relationship between management and the board of directors. While directors should have full access to any consultants that are ultimately retained by the company and have the ability and time to ask focused questions of them, the use of consultants is not legally required, and a consultant's judgment should not be viewed as a substitute for a board of directors' exercise of judgment after careful and informed deliberation. As a matter of good corporate governance, a compensation committee should understand the nature and scope of services that consulting firms and their affiliates provide to the company to evaluate any actual or perceived conflicts of interest.

2018, 2019 WL 347934 (Del. Jan. 29, 2019), which involved a stockholder's books-and-records demand under Section 220 of the DGCL. The trial court permitted Palantir to exclude email from its production, but the Delaware Supreme Court reversed, holding that while a stockholder's inspection rights are generally properly limited to formal board-level materials such as meeting minutes, resolutions and presentations, Palantir's "history of not complying with required corporate formalities," including its failure to maintain any board-level documents responsive to the inspection demand, made necessary its production of responsive emails. *Id.* at *12. The decision makes clear that the diligent preparation and maintenance of minutes can help corporations avoid intrusive inspection requests from stockholders. *See also* Wachtell, Lipton, Rosen & Katz, Delaware Provides Guidance on Books-and-Records Inspection Rights (Jan. 31, 2019), available here.

F. Compensation Committee Chairperson

While each member of a compensation committee contributes to its effectiveness, the compensation committee chairperson has a unique role. The compensation committee chairperson is responsible for ensuring that compensation committee meetings run efficiently and that each agenda item receives the appropriate level of attention. The compensation committee chairperson also often serves as the key contact between the compensation committee and other directors and senior management.

Consequently, in choosing the compensation committee chairperson, a board of directors should seek to select a director with leadership skills, including the ability to forge productive working relationships among compensation committee members and with other directors and senior management. No matter who is appointed compensation committee chairperson, as part of the annual review of the compensation committee, the compensation committee and the board of directors should review the combination of talent, knowledge and experience of the compensation committee members to ensure that the compensation committee has the right mix of people.

The time commitment resulting from the current regulatory and shareholder activist environment may require additional compensation for directors, and this pressure is especially acute with respect to service on a compensation committee. Although some companies would prefer not to discriminate in compensation among directors, reasonable additional fees for compensation committee members are legal and may be appropriate. Additional compensation for committee chairs is another way to give fair compensation for those members most burdened with responsibilities.

X.

Compensation Committee Charters

Under the SEC's executive compensation disclosure rules, a public company must disclose whether or not it has adopted a compensation committee charter, and any such compensation committee charter must be made publicly available on the company's website or attached to the proxy or information statement at least once every three years. In addition, as described below, the NYSE and Nasdaq require a listed company to adopt a compensation committee charter that must include specified provisions. In light of these requirements, the compensation committee of a publicly held company should have a charter that complies with applicable regulations and securities market requirements rules. In addition, it has become common in recent years to add to compensation committee charters the responsibility for company-wide oversight of human capital management generally, including diversity and inclusion, and in some cases to change the name of the committee to reflect this expanded role.[97] That said, any such compensation committee charter should not over-engineer the operation of the compensation committee. If a compensation committee charter requires review or other action and the board of directors or compensation committee has not taken that action, the failure may be considered evidence of lack of due care. To avoid inadvertent charter violations, companies should be thoughtful about the obligations specified in the charter and then ensure that all such obligations are covered when preparing the annual meeting calendar and agendas. The creation of compensation committee charters is an art that requires experience and careful thought; it is a mistake to copy blindly the published models.

Each company should tailor its compensation committee charter to address the company's particular needs and circumstances, limiting the charter to what is truly necessary and what is feasible to accomplish in actual practice. To be state of the art, it is not necessary that a company have everything other companies have. A compensation committee charter should carefully be reviewed each year to prune unnecessary items and to add only those items that will, in fact, help the compensation committee members in discharging their duties.

Exhibit A to this Guide is a model compensation committee charter. This compensation committee charter is only an example intended to reflect required and recommended provisions for a compensation committee

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[97] Compensation Committees & Human Capital Management, Harvard Law School Forum on Corporate Governance available here.

charter. Companies should customize a charter to address their particular needs and circumstances.

A. NYSE-Listed Company Charter Requirements

The compensation committee of a company listed on the NYSE must have a written compensation committee charter that, at a minimum, contains the required provisions specified by the NYSE listing standards.[98] The compensation committee charter must be approved and adopted by the board of directors and should provide:

- a description of the compensation committee's purpose. In this regard, the compensation committee charter should indicate that the compensation committee is appointed by the board of directors to discharge the responsibilities of the board of directors relating to compensation of the company's CEO, as well as the other executive officers (including making recommendations to the board of directors regarding such compensation). In addition, as applicable, it should indicate that the compensation committee is charged with overall responsibility for approving and evaluating all compensation plans, policies and programs of the company as they affect the CEO and other executive officers;

- that the compensation committee annually will review and approve corporate goals and objectives relevant to CEO compensation, evaluate CEO performance in light of those goals and objectives and determine and approve the CEO's overall compensation levels based on this evaluation. It also should be noted that, in determining the long-term incentive component of CEO compensation, the compensation committee will consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years;

- that the compensation committee will review and discuss with management the CD&A and, based on this review and analysis, determine whether or not to recommend to the board of directors the CD&A's inclusion in the company's proxy statement and annual report on Form 10-K;

- that the compensation committee shall furnish the compensation committee report required by the SEC;

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[98] *See* NYSE Listed Company Manual Section 303A.05. A listed company of which more than 50% of the voting power is held by an individual, a group or another company is exempt from these requirements.

- that the compensation committee may, in its sole discretion, retain advisors only after taking into consideration all factors relevant to advisor independence, including the six factors set forth in Section 303A.05(c) of the NYSE Listed Company Manual and will be directly responsible for the appointment, compensation and oversight of the advisor;

- that the company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any advisors retained by the compensation committee;

- the compensation committee's membership requirements, including the need for member independence;

- how compensation committee members are appointed and removed;

- the compensation committee's structure and operations, including authority to delegate to subcommittees;

- the procedures for compensation committee reporting to the board of directors; and

- that the compensation committee will perform an annual self-evaluation of its performance.

B. Nasdaq-Listed Company Charter Requirements

The Nasdaq rules require the compensation committee of a Nasdaq-listed company to have a formal written charter. On an annual basis, the compensation committee must review and reassess the adequacy of the charter. The charter must specify:

- the scope of the compensation committee's authority and responsibilities, and how it carries out those responsibilities, including structure, process and membership requirements;

- the compensation committee's responsibility for determining, or recommending to the board of directors for approval, the compensation of the CEO and all other executive officers;

- that the CEO may not be present during voting or deliberations on his or her compensation;

- that the compensation committee may, in its sole discretion, retain advisors only after taking into consideration factors relevant to advisor

independence set forth in Nasdaq Listing Rule 5605(d)(3) and will be directly responsible for the appointment, compensation and oversight of the advisor; and

- that the company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any advisors retained by the committee.

C. Other Potential Items for Inclusion in Compensation Committee Charters

In addition to the provisions required by the NYSE and Nasdaq rules to be included in the compensation committee charter, it may also be advisable for the charter to provide:

- that the compensation committee will, at least annually, review and approve the annual base salaries and annual incentive opportunities of the CEO and other executive officers;

- the compensation committee will review and approve the following as they affect the CEO and other executive officers: (1) all non-annual incentive awards and opportunities, including both cash-based and equity-based awards and opportunities, (2) any employment agreements and severance arrangements, (3) any change in control agreements and change in control provisions affecting any elements of compensation and benefits, and (4) any special or supplemental compensation or benefits, including supplemental retirement benefits and perquisites provided during and after employment; and

- that the compensation committee will review and reassess the adequacy of the compensation committee charter annually and recommend any proposed changes to the board of directors for approval.

However, because every company is different, a board of directors, in conjunction with the compensation committee, should carefully consider whether inclusion of any provision is helpful in furthering the performance of the compensation committee's duties.

XI.

Director Compensation, Indemnification and Directors and Officers Insurance

A. Director Compensation

Director compensation is one of the more difficult issues on the corporate governance agenda and has been the subject of increased attention in recent years. On the one hand, more is expected of directors today in terms of time commitment, responsibility, exposure to public scrutiny and potential liability. On the other hand, the higher a director's pay, the greater the likelihood that such pay can be used against the director as evidence of a lack of true independence, or can be used to make claims of excessive director compensation.

1. Responsibility for Determining Director Compensation

The NYSE and Nasdaq rules do not specify that responsibility for director compensation must be assigned to any particular committee. However, it should be made the responsibility of either a committee of the board of directors or the full board of directors. Since director compensation is typically determined by either the Compensation Committee or the Nominating and Governance Committee, we have included this Chapter regarding the issues of publicly disclosed compensation at public companies generally.

As discussed in Chapter II of this Guide, when directors who would directly benefit from a proposed plan are delegated the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plan as it relates to the company's shareholders.[99] Care also should be taken that, under normal circumstances, the compensation and benefits of management are not increased at the same time as that of directors, lest doubt be cast on the validity of both actions.[100]

2. Considerations for Determining Director Compensation

In General. While directors are not employees and compensation is not the main motivating factor for public company directors, given the importance of board composition and the competition for the best

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[99] *See, e.g.*, *Tate & Lyle PLC* v. *Staley Continental, Inc.*, 1988 Del. Ch. LEXIS 61, at *20–22 (Del. Ch. May 9, 1988) (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).

[100] *See id.*

candidates, it is important to evaluate whether director compensation programs are appropriate to the company's needs. Accordingly, as boards go through their self-evaluations, it is worthwhile to evaluate whether such programs are adequate to secure and retain best-in-class directors, or whether the programs need adjustment consistent with the increased demands of board service.

Meeting Fees and Retainers. Companies also should give careful thought to the mix between individual meeting fees and retainers. Business and regulatory demands have deepened director involvement and technology has changed the way directors meet. In view of these developments, many companies have de-emphasized per-meeting fees and instead increased retainers. Such an approach offers the dual benefits of simplifying director pay and avoiding issues that arise from electronic forms of communication and frequent, short telephonic meetings. As companies move away from per-meeting fees to retainer structures, they should consider whether additional retainer pay is appropriate for directors serving on committees that impose substantial extra demands. It is both legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time. It is also appropriate to consider the level of time commitment required outside of meetings, including for members of audit and compensation committees who must frequently review substantial written material to be properly prepared for their meetings.

Additional Director Responsibilities. The increased responsibility imposed on directors generally is especially pronounced for non-executive board chairs, lead directors and committee chairs. Accordingly, particular attention should be paid to whether these individuals are being fairly compensated for their efforts and contributions. We expect the pay of non-executive board chairs and lead directors to increase as pay practices catch up to the demands of the responsibilities of these positions.

Determining Compensation. The board of directors, a compensation committee, a nominating committee or other responsible board of director committee, as applicable, should determine the form and amount of director compensation to be paid, with appropriate benchmarking of such compensation against that of peer companies. Additionally, as with executive officers, any perquisites or other forms of compensation that may be provided to directors should be carefully considered, especially in light of the positions taken by shareholder advisory firms, such as ISS, in certain circumstances.[101] Boards of directors may also wish to consider

[101] *See* Chapter VIII of this Guide for a discussion of ISS views on director equity compensation plans.

including within the applicable equity incentive plan an annual limit on non-employee director equity-based awards or total compensation, to help avoid and defend against nuisance litigations that we have seen arise in the last few years.

In our experience, most compensation consultants can provide assistance in such benchmarking exercises, as well as in the design of director compensation programs. Survey data will prove useful in considering appropriate director compensation, and in light of ISS guidelines regarding how it determines "excessive" director compensation, has almost become an imperative when setting director compensation.[102]

Finally, the committee tasked with determining director compensation should also consider the stock ownership guidelines applicable to the directors, both in terms of the number of shares and the period of time over which a new director is required to serve in order to achieve the guideline requirement. Compensation consultants can also be useful in providing survey data as to ownership requirements—both as to level, type and period of time required to meet these requirements—at peer companies.

In all instances, the importance of collegiality to the proper functioning of a board of directors must be kept in mind; director compensation should not promote factionalism on the board. Differences in compensation among directors should be fair and reasonable and reflect real differences in demands placed on particular directors.

Note on Disclosure. As discussed in Chapter II of this Guide, the SEC's compensation disclosure rules require tabular and narrative disclosure of all director compensation. The required tabular disclosure is comparable to the extensive disclosure that is required for executive officer compensation, except that only information concerning the last fiscal year needs to be disclosed. The narrative disclosure requires a description of the company's processes and procedures for the consideration and determination of director compensation.

3. Shareholder Advisory Firm Guidance

ISS and Glass Lewis have issued guidance regarding director compensation:

- *ISS*. ISS may issue an adverse vote recommendation for board members approving non-employee director pay if there is a "recurring

[102] For a recent survey of director compensation arrangements, see *F.W. Cook & Co., Inc. 2022 Director Compensation Report* (Dec. 2022), available here.

pattern of excessive non-employee director pay magnitude without disclosure of compelling rationale," where the pattern is identified in two or more consecutive years, or without other "mitigating factors." ISS has indicated that it may consider director pay excessive if it exceeds pay received by the top 2% of directors within the same index and sector.

ISS has indicated that it would view any of the following circumstances, if within reason and adequately explained, as mitigating an excessive pay concern: (1) one-time onboarding grants that are clearly identified as such; (2) payments related to corporate transactions or special circumstances (such as special committees service, requirements related to extraordinary need, or transition payments to a former executive for a limited period); and (3) payments made in consideration of specialized scientific expertise. High non-employee director pay that arises from general performance of duties, consulting agreements with an indefinite term, and problematic payments (*e.g.*, performances-based awards, perquisites and retirement benefits) will generally not qualify as pay that arises from mitigating circumstances.

As a reminder, ISS considers non-employee director pay an "outlier" if above the top 2% of all comparable directors within the same index and sector, recognizing that board chair and lead independent director pay is often at a premium and should be compared as a separate category.

- *Glass Lewis*. Glass Lewis's guidance is less specific than ISS's, providing generally that it will be supportive of fees that are competitive and that reasonably compensate directors for their time and effort without imposing an excessive financial cost on the company. However, Glass Lewis believes that, for directors to serve as a check on imprudent risk-taking in executive compensation, directors should not be compensated in the same manner as executives and that directors should not be granted performance-based equity awards.

B. Director Compensation Litigation

In recent years, plaintiffs have focused on director compensation arrangements, and have achieved some limited successes in the Delaware courts. However, it remains the case that properly designed director compensation arrangements approved after appropriate consideration should not prove vulnerable to challenge. But the relatively recent decisions summarized below provide a strong reminder of the need for

directors to apply the highest level of care when setting their own compensation.

In April 2015, the Delaware Chancery Court in *Calma* v. *Templeton* allowed a claim that Citrix Systems' board of directors had breached its fiduciary duties in awarding compensation to its outside directors under a compensation plan that had been approved by shareholders to proceed.[103] The suit challenged awards under the existing equity incentive plan, which had been approved by a majority of shareholders a few years earlier. Potential participants in the shareholder-approved plan included all employees, directors, and officers of Citrix; the plan contained a general limit of 1,000,000 shares per participant per year (worth over $55 million at the time of the litigation), but no sublimit for directors.

The Court determined that the entire fairness standard of review (less deferential than the usual business judgment standard) was applicable because the awards to the outside directors were made by the recipient directors themselves: "[D]irector self-compensation decisions are conflicted transactions that 'lie outside the business judgment rule's presumptive protection.'"[104] The directors' primary defense was that the equity plan had been ratified by shareholders; however, in light of the lack of meaningful limits or specific guidelines for awards to non-employee directors, the Court held that shareholder approval of the plan as a whole did not constitute approval of the specific decision of the board to make the grants in question.[105]

The *Calma* decision built on a 2012 Delaware Chancery Court decision, *Seinfeld* v. *Slager*,[106] involving director equity awards under a plan with an individual share limit (worth approximately $30 million at the time of the litigation). The *Seinfeld* Court held that "there must be some *meaningful* limit imposed by the stockholders on the Board for the plan to . . . receive the blessing of the business judgment rule. . . . A stockholder-approved *carte blanche* to the directors is insufficient."[107]

In 2016, Facebook settled a shareholder derivative complaint alleging breach of fiduciary duty, waste and unjust enrichment in connection with the board's approval of an annual cash and equity compensation program for non-employee directors in 2013 by committing to several governance steps, most notably an agreement to submit various elements of its director

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[103] *Calma* v. *Templeton*, 114 A.3d 563 (Del. Ch. Apr. 30, 2015).

[104] *Id.* at 578 n.54 (citation omitted).

[105] *Id.* at 587–89.

[106] 2012 Del. Ch. LEXIS 139 (Del. Ch. June 29, 2012).

[107] *Id.* at 41.

compensation program to a shareholder vote that would not otherwise be required, and by agreeing to pay the plaintiff's legal fees reported to be $525,000. Most practitioners are of the view that the Facebook plaintiffs would not have succeeded on the merits, and presume that Facebook settled to avoid the cost and distraction of litigation. Nonetheless, the case serves as a cautionary example of the desirability of taking steps to decrease the likelihood of attracting claims related to director compensation, particularly because the size of the attorney's fees may inspire further such claims.[108]

In late 2017, the Delaware Supreme Court overruled a lower court regarding the standard of review that is required when a challenge is made to director compensation awards granted under shareholder-approved equity incentive plans.[109] In *Investors Bancorp*, the Delaware Court of Chancery concluded that because the company's shareholder-approved equity incentive plan contained a "meaningful limit" on the number of shares that could be granted to directors, though the grants that the company's directors made to themselves were large they fell within these plan limits, and, therefore, the company could properly invoke a defense that the shareholders had effectively ratified these grants.[110] The Delaware Supreme Court reversed this decision, holding that the grants were subject to an "entire fairness" standard of review, which is a higher standard than the typical "business judgment" standard of review that applies to most director actions.[111]

In 2019, the Delaware Court of Chancery allowed a challenge to director compensation at Goldman Sachs to proceed under the entire fairness standard.[112] While casting doubt on the merits of the plaintiffs' allegations, the court rejected the company's position that an equity plan provision that by its terms provided that directors could not be found liable for actions taken in good faith obviated the need for application of entire fairness review.

Directors and company executives of Delaware corporations may wish to consider including, in new or amended equity incentive plans otherwise being put to a shareholder vote, realistic limits on director awards, specifying the amount and form of individual grants to directors or a meaningful and reasonable director-specific individual award limit, and also consider including overall limits on director compensation. While

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[108] *Espinoza* v. *Zuckerberg*, 124 A.3d 47 (Del. Ch. 2015).

[109] *In re Inv'rs Bancorp, Inc. Stockholder Litig.*, C.A. No. 169, 2017, 2017 Del. LEXIS 517 (Del. Dec. 13, 2017), *rev'g* 2017 Del. Ch. LEXIS 53 (Del. Ch. Apr. 5, 2017).

[110] *Id.* at *13 (discussing the Court of Chancery's decision).

[111] *Id.* at *30.

[112] *Stein* v. *Blankfein et al.*, C.A. No. 2017-0354-SG (Del. Ch. May 31, 2019).

these limits are not required under any rule, and while some commentators have questioned their value in defense litigation in light of *Stein*, we continue to believe that they may help to deter, or bolster a defense against, claims challenging the amount or form of director compensation.

Moreover, in light of recent proxy advisory firm guidance and continued litigation pressures, it is as prudent as ever for a board to rely on a compensation consultant to assist in constructing the appropriate peer group for benchmarks and to advise on the amount and design of any proposed director compensation, as this may also assist in the protection against claims attacking director compensation.

C. Indemnification and Directors and Officers Insurance

A directors should be fully indemnified by the company to the fullest extent permitted by law and the company should purchase a reasonable amount of insurance to protect the directors against the risk of personal liability for their services to the company. Bylaws and indemnification agreements should be reviewed on a regular basis to ensure that they provide the fullest coverage permitted by law. Directors also can continue to rely on their exculpation for personal liability for breaches of the duty of care under charter provisions put in place pursuant to state law.

Directors and Officers ("D&O") insurance coverage, of course, provides a key protection to directors. D&O policies are not strictly form documents; they can and should be negotiated. Careful attention should be paid to retentions, exclusions, and the scope of coverage. Care also should be given to the potential effect of a bankruptcy of the company on the availability of insurance, particularly the question of how rights are allocated between the company and the directors and officers who may be claiming entitlement to the same aggregate dollars of coverage. To avoid any ambiguity that might exist as to directors' and officers' rights to coverage and reimbursement of expenses in the case of a bankruptcy, companies should purchase separate supplemental insurance policies covering only directors and officers, but not the company (so-called Side-A coverage), in addition to the policies that cover both the company and the directors and officers individually.

* * * * *

This Guide is not intended as legal advice, cannot take into account particular facts and circumstances (including the extent to which certain federal fiduciary laws may apply to a given compensation committee), and generally does not address individual state or non-U.S. corporate laws. Applicability of the information contained herein to specific situations should be determined through consultation with legal, tax and accounting advisors.

EXHIBIT A

COMPENSATION [AND MANAGEMENT DEVELOPMENT] COMMITTEE CHARTER

Purposes

The primary purposes of the Compensation [and Management Development][113] Committee (the "Committee") of the Board of Directors (the "Board") of **[Name of Company]** (the "Company") are to:

- discharge the Board's responsibilities relating to the compensation of the Company's Chief Executive Officer (the "CEO") and other executive officers (collectively, including the CEO, the "Executive Officers");
- provide oversight of the Company's executive compensation plans, policies and programs as they affect the Executive Officers;
- [review, assess, and make reports and recommendations to the Board as appropriate on succession planning with respect to the Executive Officers;][114] and
- [assist with Board oversight of the Company's culture and strategies relating to human capital management.][115]

This charter (this "Charter") sets forth the authority and responsibilities of the Committee in fulfilling its purpose.

Membership

The Committee will consist of no fewer than three members, with the exact number determined by the Board.

The members of the Committee will be appointed annually by the Board on the recommendation of the Nominating & Governance Committee and will serve at the Board's discretion. Committee members may be replaced

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[113] Consider the Committee's name and desired scope of responsibilities.

[114] It is not unusual for succession planning to be under the purview of the Nominating and Corporate Governance Committee rather than the Compensation Committee. Consider the desired division and scope of responsibilities relating to succession planning.

[115] It is not unusual for responsibility for human capital management to be under the purview of either the Compensation Committee or the Nominating and Corporate Governance Committee. Consider the desired division and scope of responsibilities relating to human capital management.

or removed from the Committee by the Board at any time, with or without cause, and any vacancies will be filled through appointment by the Board on the recommendation of the Nominating & Governance Committee. Resignation or removal of a director from the Board will automatically constitute resignation or removal, as applicable, of such director from the Committee.

The Board will appoint one member of the Committee as its Chairperson (the "Committee Chair").

All members of the Committee will meet the independence requirements of the listing standards of the securities exchange on which the Company's securities are listed and any other applicable laws, rules or regulations (including the rules and regulations of the U.S. Securities and Exchange Commission) or other qualifications as are established by the Board from time to time. At least two members of the Committee will also qualify as a "non-employee" director within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934, as amended.

[Notwithstanding the foregoing, the Company may avail itself of any phase-in rules and interpretations applicable to newly listed companies in connection with an initial public offering.][116]

Meetings and Actions Without a Meeting

The Committee will meet as often as it determines necessary to carry out its responsibilities. The Committee Chair will preside at each meeting. In the event the Committee Chair is not present at a meeting, the Committee members present at that meeting will designate one of its members as the acting chair of such meeting. The Committee may also act by unanimous written consent in lieu of a meeting in accordance with the Company's Bylaws.

Authority and Responsibilities

The principal responsibilities of the Committee are set forth below. The Committee may perform such other functions as are consistent with its purpose and applicable laws, rules and regulations and as the Board may request or as the Committee deems necessary or appropriate.

The Committee will:

[116] If applicable.

Compensation and Benefit Programs

1. Periodically review and approve the Company's compensation strategy and practices with respect to the Executive Officers.

2. Annually review and approve corporate goals and objectives relevant to the CEO's compensation, evaluate the CEO's performance in light of those goals and objectives and determine and approve the CEO's overall compensation levels based on this evaluation. [In determining the long-term incentive component of the CEO's compensation, the Committee may consider any number of factors, including the Company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the CEO in past years.][117] [The CEO may not be present during voting or deliberations on his or her own compensation.][118]

3. At least annually review and approve (and, if desired, make recommendations to the Board for approval of) the compensation of the Executive Officers, including annual base salaries, short- and long-term (including cash-based and equity-based) incentive awards and opportunities, and perquisites or other personal benefits, except to the extent such benefit policies or programs apply to Company employees generally.

4. Periodically and as and when appropriate, review and approve the following as they affect the Executive Officers:

   (a) any employment and severance arrangements;

   (b) any change in control agreements and change in control provisions affecting any elements of compensation and benefits; and

   (c) any special or supplemental compensation and benefits for the Executive Officers and individuals who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

5. Perform such duties and responsibilities as may be assigned to the Committee under the terms of any equity-based plan or other compensation plan.

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[117] Bracketed language lists considerations that the NYSE Listed Company Manual states the Committee should consider when determining the long-term incentive component of CEO compensation.

[118] This statement is required for Nasdaq-listed companies.

Compliance and Governance

6. Review and discuss with management the Compensation Discussion and Analysis required to be included in the Company's proxy statement and annual report on Form 10-K and prepare the annual Compensation Committee Report for inclusion in the Company's proxy statement.

7. Consider the results of advisory votes on executive compensation and the frequency of such votes.

Management Development and Culture[119]

8. [Review annually with the Board an evaluation of the performance of the CEO and other Executive Officers.]

9. [Periodically review and discuss with the Board and, as the Committee deems appropriate, the Nominating and Corporate Governance Committee, the corporate succession plan for Executive Officers.] [Periodically review [and approve] a written talent management program that provides for development, recruitment, and succession of Executive Officers, review diversity programs, and make recommendations to the Board regarding Executive Officers.][120]

10. [Review and assess reports from management and make reports and recommendations to the Board as appropriate, on the Company's culture and strategies relating to human capital management, including talent development, performance against talent and diversity goals, significant conduct issues, and any related employee actions (including, but not limited to, compensation actions), in each case, at the highest management levels.][121]

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[119] Consider including Items 8–10 if the Committee will have broad authority for management development and culture generally.

[120] It is not unusual for succession planning to be under the purview of the Nominating and Corporate Governance Committee rather than the Compensation Committee. Consider the desired division and scope of responsibilities relating to succession planning.

[121] It is not unusual for responsibility for human capital management to be under the purview of either the Compensation Committee or the Nominating and Corporate Governance Committee. Consider the desired division and scope of responsibilities relating to human capital management.

Assessment

11. [At least annually, review and evaluate the performance of the Committee.][122]

12. [Annually review and reassess the adequacy of this Charter and recommend any proposed changes to the Board for approval.][123]

Advisors

The Committee may, in its sole discretion, retain or obtain the advice of compensation consultants, outside legal counsel, or other advisors. The Committee will have sole authority to approve the advisor's fees (the expense of which will be borne by the Company) and other terms and conditions of the advisor's retention.

To the extent required by the rules of the securities exchange on which the Company's securities are listed, the Committee will conduct an independence assessment, taking into consideration the factors set forth in such rules and any other factors the Committee deems relevant to the advisor's independence from management, prior to selecting or receiving advice from such advisor.

Meetings and Reports

The Committee will maintain written minutes of its meetings and copies of its actions by written consent, and will file such minutes and copies of written consents with the minutes of the meetings of the Board.

The Committee will report periodically to the Board, generally at the next regularly scheduled Board meeting following a Committee meeting, on actions taken and significant matters reviewed by the Committee.

Delegation of Authority

The Committee may from time to time as it deems appropriate, and to the extent permitted by applicable laws, rules and regulations, form and delegate authority to subcommittees consisting of one or more members when appropriate.

* * *

[122] An annual performance evaluation is required by the NYSE.

[123] The Nasdaq rules require the charter to be reviewed annually.

February 17, 2023

PGA Tour wins major victory in litigation with Kingdom of Saudi Arabia

In a significant victory for the PGA Tour in its litigation with Saudi-backed LIV Golf, the District Court for the Northern District of California has ordered the sovereign wealth fund of Saudi Arabia—the Public Investment Fund, or "PIF"—and its leader, Yasir Al-Rumayyan, to produce documents and sit for deposition testimony, rejecting claims of sovereign immunity and jurisdictional objections.

After reviewing the parties' submissions and significant evidence demonstrating PIF's and Al-Rumayyan's creation and control of LIV, the Court held that, "[i]t is plain that PIF is not a mere investor in LIV; it is the moving force behind the founding, funding, oversight, and operation of LIV."

In its 58-page, well-reasoned decision, the Court rejected PIF's attempts to invoke sovereign immunity and avoid discovery. The Court found that PIF's "carefully-worded and conclusory denials" could "not overcome the evidence" of its commercial activities, which are not protected by sovereign immunity under relevant statutes or the common law.

The Court likewise rejected PIF's and Al-Rumayyan's personal jurisdiction defenses, finding that "PIF and Mr. Al-Rumayyan purposefully directed their activities at the United States" and that the exercise of jurisdiction over them is not "unreasonable."

As a result of the order, PIF and Al-Rumayyan must produce documents relating to, among other things, their recruitment of players to join LIV, their payment of player's legal fees in connection with the litigation, and the PGA TOUR. A representative for PIF and Al-Rumayyan also must now appear for a deposition, where they will be questioned under oath by attorneys for the PGA TOUR.

The order is believed to be the first time a U.S. court has held that PIF and Al-Rumayyan are subject to jurisdiction and discovery in U.S. court proceedings. The order may have broader implications beyond the litigation, given that Saudi Arabia, through PIF, is a major investor throughout the United States.

Edward D. Herlihy
David B. Anders

February 16, 2023

Private Equity—2023 Outlook

Despite the challenges the year presented for investors (rising interest rates, tumultuous financial markets, geopolitical upheaval, etc.), private equity showed resilience in 2022. Deal activity declined from 2021, but finished the year above pre-pandemic levels. Although fundraising similarly slowed, sponsors still closed 2022 with approximately $2 trillion in dry powder. And while private equity continues to face headwinds in 2023, market dislocations often provide compelling opportunities for the most thoughtful and sophisticated investors. Now more than ever, creative financing and careful transaction planning are essential.

We review below some of the key themes that drove private equity deal activity in 2022 and our expectations for 2023.

Acquisitions and Exits

Deal Activity Down From 2021, But Above Pre-Pandemic Levels. As we described in our recent memo, Mergers and Acquisitions—2023, after a record-shattering year for M&A in 2021, last year represented a reversion to the mean.

- *Deal volumes down.* Announced global private equity M&A deal volume declined from $2.1 trillion in 2021 to $1.4 trillion in 2022, with dealmaking tapering in the second half of the year as credit markets weakened and became more volatile. Private equity's share of overall M&A volume was steady year-over-year (approximately 36%), and deal volume in 2022 exceeded the pre-pandemic level of $1 trillion in 2019.

- *Public buyout boom continues*. While aggregate deal volume shrank, sponsors were active in public company buyouts in 2022, supported by the significant decline in public company market valuations and sponsors' desire to deploy large amounts of capital. 2022 capped a two-year take-private boom, with 2021 and 2022 each, by both deal count and value, marking the highest levels of public company buyout activity since the 2008 financial crisis.

As always, many sponsors were agile in reacting to the dynamics of the broader economy and financial markets. Those that did deals were generally perceived as pressing their advantages of access to capital, relationships and comfort with complexity to create and exploit opportunities—from the increasing use of continuation funds to manage timing of an exit, to obtaining deal flow from hedge fund activism, to deploying sophisticated financing structures that allow portfolio companies to manage through challenging market conditions. We discuss some of these trends in greater detail below.

Sponsors Choosing Alternative Exits. The aggregate value of private equity exits globally was down 32% from 2021. Responding to the challenging IPO and corporate buyer markets in 2022, sponsors pivoted to alternative exits. Sponsor-to-sponsor sales (including continuation funds) accounted for approximately 45% of U.S. private equity deal volume in 2022, an uptick from the 10-year average of approximately 39%.

- *Continuation funds a source of liquidity.* Many sponsors elected to hold on to portfolio companies rather than sell into a down market, or to transfer assets to continuation funds. While continuation fund transactions require dealmakers to navigate potential conflicts and are the subject of increasing SEC focus, they provide an alternative path that can be attractive to both managers and limited partners. With $125 billion of capital currently being raised to target continuation opportunities, we expect this trend to continue into 2023, particularly if the challenging market backdrop for IPOs and sales to strategics continues.

Tech Still Prominent. As in 2021, the technology sector was a key area of interest for private equity.

- *Software popular.* Software companies with a "recurring-revenue" business model remained a notable area of focus for private equity buyers. As software valuations declined sharply as part of a broader tech selloff, sponsors launched a number of public company buyouts targeting the space. Examples include Thoma Bravo's $6.9 billion acquisition of SailPoint and $8 billion acquisition of Coupa Software, and Vista's $8.4 billion acquisition of Avalara.

- *Looking ahead.* We expect tech to continue to be an area of focus for sponsors, who increasingly see the sector as a way to gain exposure to broad swaths of the economy, as digitalization and technology permeate an ever-wider range of industries.

Importance of Activism. Activism by hedge funds continues to be a source of deals for sponsors, including through joint bids or complementary playbooks, and being invited into a deal process when activists are already on the scene.

- *Activists catalyzing buyouts.* Activism increased in 2022, and as activists took advantage of declines in valuations to agitate for sales, sponsors often emerged as buyers. Notable campaigns included JANA's campaign at Zendesk preceding the company's $10.2 billion sale to a consortium of investors led by Hellman & Friedman and Permira, and Sachem Head and Corvex Management's campaign at Anaplan preceding the company's $10.7 billion sale to Thoma Bravo. We expect that hedge fund activists will continue to push for M&A in various sectors in 2023, and sponsors will increasingly take advantage of the opportunities this may create.

- *And also opposing them.* Activists also continue to advocate against agreed M&A transactions, highlighting the increasing importance to sponsors acquiring public companies of planning ahead for possible campaigns seeking to disrupt agreed buyouts. For example, after Nielsen agreed to be acquired by Evergreen Coast Capital Management (the private equity arm of Elliott Investment Management) and Brookfield Asset Management, The WindAcre Partnership sought to oppose the take-private transaction. WindAcre ultimately joined the buyout consortium and the transaction closed.

Deal Financing

Creative Transaction Structuring. Responding to the 2022 credit market turmoil, sponsors increasingly turned to creative financing structures to pursue new deals.

- *Buy now, borrow later.* Some sponsors followed a "buy now, borrow later" path—up to and including all-equity deals, such as KKR's buyout of April Group—writing large equity checks and planning to increase leverage when markets improve.

- *You can take it with you…* Also en vogue were deal structures that allow a target's existing debt to stay in place post-transaction—for instance BDT Capital's purchase of Weber. This approach, while "debt-efficient," can limit buyout opportunities to more modest transactions, such as capping the new investment below 50%, and otherwise moderating consent and board rights to avoid tripping change-of-control provisions. Such was the case, for instance, in Kohlberg's "secondary" transaction to buy a 50% stake of USIC from Partners Group.

- *Seller notes.* In certain situations, *e.g.*, where the seller is a large strategic shedding non-core assets, buyers looked to "seller notes" and other forms of seller-provided financing to close the funding gap. For instance, Searchlight Capital Partners' and Rêv Worldwide's acquisition of Netspend from Global Payments was funded, in part, by Global Payments-provided financing.

Liability Management Transactions: The Modern Dynamic. The market and rate environment has created challenges—and liquidity needs—for many businesses, and sponsor-owned companies have not been immune. But under modern debt documents, sponsors and their portfolio companies have a diverse array of debt transaction tools available to obtain liquidity for their cash-strapped portfolio companies, often while capturing discount and extending maturities in the process.

- *Uptiers and dropdowns*. One such tool is the so-called "uptier," in which a majority lender group consents to the incurrence of priming senior debt (and often exchanges a portion of its existing debt for such priming senior debt). Alternatively, sponsors may consider a "dropdown" in which company assets are transferred from the debt credit

group to an "unrestricted subsidiary," which then raises its own financing (sometimes in connection with a discounted exchange for the debt of its parent company). When successfully implemented, these transactions can materially improve the balance sheet where lenders may be reluctant to participate in a refinancing.

- *Meticulous analysis essential.* Liability management transactions have also spawned complex legal disputes—see, *e.g.*, *Serta, Boardriders* and *Revlon*, all situations involving liability management transactions by sponsor-controlled companies in which litigation is currently ongoing. Careful advance planning, and a proper board process that evaluates conflicts and insulates board members (and the sponsor) from attack, are essential.

The Rise and Rise of Direct Lending. As challenging syndicated markets failed high-yield issuers, "direct lenders" partially filled the breach.

- *Prominent in PE.* Once limited to the middle market, direct lenders reportedly provided some or all of the debt financing in six of the 10 largest announced buyouts of 2022.

- *And still some room to grow.* The pace of direct lending slowed in the second half of 2022, but still remained relatively robust when compared to traditional single B financing markets. As top direct lending players raise bigger funds and make increasingly large commitments, their prominence may only increase.

Funds and Fundraising

Fundraising Down, But Capital Reserves Remain Robust. After private equity funds reported record inflows from investors in 2021, fundraising was estimated to be down approximately 22% for 2022. But global private equity and venture capital dry powder remains robust, standing at nearly $2 trillion, with approximately one-third earmarked for traditional leveraged buyouts.

Private Equity Opening Up to Retail. 2022 saw private equity firms pushing to develop private capital retail offerings, with asset managers such as Apollo, Blackstone and KKR looking to grow assets under management and high net worth individuals seeking higher-returning investments. Notwithstanding recent challenges posed by higher-than-expected levels of investor redemption requests, leading some sponsors to implement redemption gates as permitted by fund documents, we expect the number of retail-accessible alternative asset products to continue to expand, as asset managers pursue a huge and largely untapped market.

Innovations in Fund-Level Debt Financings—NAV Loans. While fund-level debt facilities—in particular "capital call" facilities—have long been a feature of PE fund structures, 2022 saw net asset value ("NAV") loan facilities, fund facilities which are

secured by the collective portfolio company equity interests held by a fund, become increasingly popular. NAV facilities can provide important financing for mid- and late-life funds, when most or all of their capital has been called.

Regulatory Developments

Increasing Antitrust Scrutiny. As we anticipated in our memo last year, private equity has moved into the spotlight of the Antitrust Division of the Department of Justice and the Federal Trade Commission.

- *DOJ targeting roll-ups.* In an interview with the *Financial Times* given in mid-2022, Jonathan Kanter, the assistant attorney general in charge of the Antitrust Division, indicated that private equity roll-ups would be a particular area of focus for DOJ.

- *Concerns with interlocking directorates.* DOJ has also indicated that it is ramping up efforts to enforce Section 8 of the Clayton Act, which prohibits officers and directors from simultaneously serving with competing companies. Private equity sponsors have become a target of enforcement, under a theory of corporate deputization, which focuses on whether the firm (as opposed to an individual) has overlapping competitive board interlocks. For example, in October 2022, seven director resignations were announced in response to concerns raised by DOJ, including three relating to Solarwinds, a Thoma Bravo portfolio company, even though only one Solarwinds board member was also a director at another Thoma Bravo portfolio company.

- *Expect increased focus on regulatory deal terms.* With regulators scrutinizing private equity, sponsors will need to devote increasing attention to the regulatory risks posed by their transactions and the contractual terms that allocate those risks, as will their counterparties. We expect some sellers to push on the traditional sponsor position that existing portfolio companies are off-limits for any sort of contractual obligation, leading to bespoke arrangements.

Greater Regulatory Attention to ESG. Attention to environmental, social and governance issues remains elevated, and continues to have implications for sponsors. In May, the SEC proposed new disclosure requirements for ESG-related funds and to require a registered fund with ESG terminology in its name to invest 80% of its assets consistent with that focus. 2022 also saw the SEC bring the first actions by its Enforcement Division's Climate and ESG Task Force, which was established in early 2021 to focus on "greenwashing," or misleading statements by firms regarding their ESG-related commitments and practices. Sponsors with ESG-focused funds will need to pay close attention to the SEC's evolving views of ESG disclosure and compliance.

Carried Interest Tax Changes Off the Table—Again and For Now. Earlier versions of the Inflation Reduction Act contemplated extending the holding period of

investments eligible for carried interest tax treatment from three to five years. These changes were removed from the final bill to secure passage in a 50-50 Senate.

* * *

Private equity heads into 2023 facing considerable uncertainty. Nonetheless, we expect markets to continue to present attractive opportunities for creative dealmakers, and to reward sponsors that can bring real value to the table with counterparties in the form of thoughtful structuring, access to capital and a reputation and record of successful execution in challenging markets.

Andrew J. Nussbaum
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Mark F. Veblen
Victor Goldfeld
John R. Sobolewski
Alon B. Harish
Charles C. See

February 1, 2023

Financial Institutions M&A 2023:
Continued Resilience in a Challenging Economic and Regulatory Environment

To our clients and friends:

We are pleased to present you with our annual Financial Institutions M&A outline.

Despite ongoing economic challenges and regulatory headwinds, the past year continued to witness some significant strategic transactional activity cutting across all segments of the financial services industry. We are grateful for the opportunity to share our insights with you.

In order to access the outline (which we are again providing in a searchable electronic format), please go to:

https://www.wlrk.com/docs/FIGMemo2023.pdf.

If you would like to receive a hard copy of the outline, we'd be glad to provide one. Please just send us an email to Publications@wlrk.com.

Thank you, and as always, we welcome your feedback, including any suggestions for topics that you would like for us to cover in future versions. We hope to see many of you in person during 2023.

With regards,

The Wachtell, Lipton, Rosen & Katz
Financial Institutions Group

January 31, 2023

White-Collar and Regulatory Enforcement:
What Mattered in 2022 and What to Expect in 2023

Introduction

Each year we try in this wrap-up memo to flag the main enforcement developments that companies should be alert to in the coming year and also to identify steps companies should be taking to prepare themselves in the event of a significant white-collar or regulatory enforcement inquiry. Because policy preferences (and politics) often shape these developments, the early days of any new administration in D.C. are frequently harder to read, and teasing apart mere rhetoric from concrete changes in enforcement priorities can be challenging. But now, two years into the Biden administration, we can see some clear themes emerging: Penalties are up—way up; investigations appear to be moving a bit faster; cryptoassets and cybersecurity have become heightened risk areas; government expectations for what constitutes full cooperation have been amped up; and many new disclosure demands across a wide range of corporate activities are coming on line. At the same time, however, several time-tested verities remain firmly in place, including the need to maintain strong internal accounting controls, provide comprehensive (and frequent) training, instill a genuinely ethics-oriented tone at the top, stay vigilant in detecting internal misconduct, and react swiftly in the event problems do arise by self-remediating and self-reporting when appropriate. A company that positions itself in this way optimizes its chances not only of securing the best possible resolution in the event of criminal or civil charges but also of forcefully resisting enforcement action where warranted.

Our general sense is that government investigators are becoming more adept at gauging whether a corporation's commitment to ethics and compliance is both genuine and commensurate with the risks its businesses entail. We also think the government is getting better at delineating when (and why) it is granting substantial credit for a robust compliance culture, effective remediation measures, and timely, comprehensive cooperation. In sum, as we look ahead, the rewards for getting compliance right are easier to see, while the costs of getting it wrong are increasing.

In the sections that follow, we describe how senior DOJ leadership delivered over the past year on its promise to provide companies with additional guidance regarding its corporate enforcement policies. Most notably, this past September, Deputy Attorney General Lisa Monaco promulgated a memo that further revised and made more transparent DOJ's policies concerning the evaluation of companies' voluntary self-disclosure of misconduct, cooperation efforts, compliance program and culture, and past history of misconduct. Since DAG Monaco's memo, other senior DOJ officials, through a series of public speeches, have built on these themes and emphasized white-collar enforcement as a key priority under the Biden administration. In January of this year, Criminal Division head Kenneth Polite announced revisions to the Corporate Enforcement Policy (CEP) that implement and refine aspects of DAG

Monaco's memo with a view to giving corporations yet more incentives to detect, report, and remediate misconduct, and engage proactively with DOJ.

The SEC has also made concrete its earlier talk of increasingly aggressive enforcement. For example, as we explain below, the Division of Enforcement "re-calibrated" its penalty-imposing ambitions and levied record high civil money penalties in 2022 for the articulated purposes of promoting deterrence and sending a signal to markets that penalties must not be seen as "another business expense." In several high-profile settlements, the SEC revived its policy of seeking admissions of wrongdoing. And recently adopted and proposed disclosure rules are likely to expose companies to new enforcement risks.

Finally, we cover below several of the key substantive areas that attracted the greatest attention in 2022, including developments in the cybersecurity, cryptoassets, antitrust enforcement, and cross-border arenas. We also review the active role played by state Attorneys General this year across a variety of sectors, most notably with respect to ESG policies, data privacy, and cybersecurity—a high level of enforcement activity that we expect to persist, and perhaps even expand, in 2023.

DOJ Developments

In October 2021, DAG Monaco issued a memo that heralded a return to Obama-era corporate criminal enforcement policies. In the memo and related remarks, the DAG and other DOJ officials championed a sweeping conception of corporate recidivism to stand as a barrier to leniency; threatened to withhold cooperation credit from companies that identified only those individuals *substantially* involved in misconduct; and encouraged prosecutors to dust off the corporate monitorship as a component of corporate criminal resolutions. The DAG also created an advisory group to help flesh out these policies. The hope expressed in our wrap-up memo last year was that, as events unfolded in 2022, DOJ would provide clarity and transparency about how it would exercise its discretion and grant credit for self-reporting and cooperation in the corporate context.

A year on, that hope has been realized to a significant degree. What is more, the refinements and clarifications DOJ has offered reflect more sensitivity to context and more flexibility than one might have predicted based on early declarations.

In September 2022, the DAG issued a follow-on memo reflecting the work of the DOJ advisory group. As we summarized at the time, some parts of that memo introduced welcome nuance and clarity. For example, the memo made it clear that before treating a company as a recidivist undeserving of leniency, a prosecutor should consider precisely what and who were involved in the prior conduct at issue, including whether the prior conduct was similar to the newly discovered conduct and whether the same personnel were involved, how long ago the prior misconduct happened, how that conduct was addressed (*i.e.*, whether there was a civil resolution, criminal charge, or some other disposition), whether the subject company operates in a highly regulated industry, and whether the prior conduct was that of an acquired entity that has since been integrated into a compliant entity. In other words, not all prior brushes with law enforcement should be weighted equally. Another heartening pronouncement was that a company that voluntarily self-discloses misconduct, cooperates fully, and adequately remediates

can avoid a guilty plea absent aggravating factors—and each DOJ component must adopt a written policy specifying what it considers an aggravating factor. Likewise, the memo clarified that a monitorship may not be warranted as part of a criminal resolution where the subject company has already implemented and tested an effective compliance program.

Further guidance on DOJ policy concerning corporate leniency—and declinations in particular—came in January 2023, with AAG Polite announcing a revised CEP that equips prosecutors with more carrots to reward self-disclosure, cooperation, and remediation. Under the new CEP, declination may be available even when certain aggravating factors are present—provided the company immediately self-discloses conduct caught by an "effective compliance program" and engages in "extraordinary" remediation and cooperation.

Our summary of the DAG's September 2022 memo applauded its transparency, because in our view the more concrete the guidance, the more effectively a well-managed company can direct its resources, address internal reports of misconduct, and respond constructively to regulatory inquiries—including by forcefully resisting enforcement action in appropriate cases. We likewise applaud the updating of the CEP to clarify that declination may be on the table even where there is an aggravating factor like executive management involvement in misconduct. But companies should make no mistake: the expectations embodied in DOJ's recent guidance are more demanding than ever for entities hoping for a favorable negotiated resolution. Companies wishing to gain credit for cooperation will be expected to produce documents and other records on a "timely" basis (emphasis in DOJ's September 2022 memo), prioritize production of—and direct prosecutors' attention to—the most relevant evidence from the most involved employees, and, where possible, resist reliance on foreign data privacy laws to avoid production of documents. As DAG Monaco's Principal Assistant, Marshall Miller, put it in a "Brooklyn-blunt" September 2022 speech, criminal charges and guilty pleas are now "on the main, everyday menu," and much is required of companies before DOJ will grant them leniency. If DOJ follows through on all of this tough talk, then companies should expect that simply cooperating in full will not necessarily result in a declination or a non-prosecution agreement. With the benefits of cooperation thus lessened and more difficult to secure, more companies may decide to run the risk of fighting in close cases.

Another principal takeaway from all of these DOJ pronouncements is that the heavy corporate lifting required for lenient treatment must start before the first subpoena arrives. Throughout 2022, DOJ officials have been emphasizing the need to create a compliant culture well in advance of regulatory scrutiny. They have urged companies to ensure their compliance programs set the right incentives for executives—including by using compensation and clawbacks to reward compliance and punish its opposite. DOJ has also now made it clear that companies hoping for cooperation credit should have effective policies for monitoring and preserving their employees' business-related communications over all platforms and media. Policies governing business-related texting, use of personal phones, and communications over ephemeral and encrypted messaging necessarily will vary depending on the company and the industry in which it operates. But a company hoping for leniency will want to ensure that it has a clear policy in place and is monitoring and enforcing compliance with that policy.

Because most DOJ investigations incubate for some time before their outcomes are publicized, it is too early to tell whether the Department's 2021 policy initiatives or their 2022 and early 2023 refinements will translate into a measurable increase in corporate criminal prosecutions and resolutions. Our prediction is that they will. No matter how intent prosecutors may be on rooting out, exposing, and deterring corporate misconduct, and however much support they may have from DOJ's leadership, resource constraints can be a significant limiter. The DAG's memos, the new CEP, and DOJ's related policy pronouncements are designed in large part to expand the prosecutor's resources by causing companies to deploy their own compliance tools and efforts in service of DOJ's mission. That marshaling of corporate resources to the government's advantage will likely yield more—and more significant—enforcement in this area.

SEC Developments

The current administration at the SEC arrived with promises of a more aggressive approach to enforcement. In the past year, we saw a variety of concrete results in keeping with that commitment, and we expect this emphasis on tougher enforcement to continue in the coming year. The Commission brought a total of 462 standalone enforcement actions in its fiscal year ended September 30, 2022. This was a 6.5% increase over the prior year, though still somewhat below each of the two years that preceded the onset of the pandemic. The case mix was broadly in line with historical patterns. Public company disclosure and accounting cases were 16% of the total, up slightly from 12% in 2021. Insider trading cases also increased somewhat, accounting for 9% of 2022's docket, compared to 6.5% in 2021. Securities offerings comprised 23% of the cases brought, but this category always includes a large number of unregistered offerings, Ponzi schemes, and similar matters—and relatively few cases involving offerings by public companies.

The administration's new approach was most strikingly illustrated in the civil money penalties the Commission extracted in 2022. Penalties ordered in SEC enforcement actions in 2022 totaled $4.194 billion—by far the most ever, and roughly three and four times the aggregate penalties levied in 2021 and 2020, respectively. In public remarks, SEC officials continue to emphasize their determination to increase penalties. Enforcement Director Gurbir Grewal's remarks at the Securities Enforcement Forum this past November are representative—he referred to the SEC's effort to "re-calibrate" penalties and expressed his desire to "get away from the idea that penalties are just another business expense." Unfortunately, rhetoric of this nature fails to recognize the strong compliance culture that exists in many companies. Such companies, when faced with SEC inquiries, should be prepared to make strong affirmative presentations about their commitment to ethical practices and strong controls.

The SEC has now also carried through on its revived policy of requiring admissions in certain settlements. In FY 2022, the SEC concluded a total of 19 settlements involving an admission of wrongdoing. A common theme running through all these cases was the Commission's finding that the subject company acted in a way that impaired the SEC's investigative function. Seventeen of the cases arose from an industry-wide investigation of broker-dealer recordkeeping practices. The respondents admitted to failing to preserve business-related communications when their employees used personal devices, rather than their employers' systems, in violation of applicable SEC rules. (These cases together also accounted for $1.235 billion out of the $4.194 billion in civil penalties ordered in the year.) The SEC noted that the recordkeeping failures hindered its ability to obtain relevant documents in numerous

investigations. Similarly, in a case against Ernst & Young for a years-long scheme in which certain of its staff cheated on CPA exams, including ethics exams, the SEC secured admissions after finding that the firm improperly withheld relevant evidence during the investigation (though one Commissioner publicly dissented from this finding). Finally, in a case against Allianz Global Investors and three of its former personnel for an extensive scheme of misrepresentations to investment advisory clients, the SEC secured admissions after alleging that the individual defendants attempted to conceal the misconduct from the SEC. While we should not expect the SEC to limit its admission-obtaining policy to circumstances involving obstruction of the SEC's work, such circumstances plainly are aggravating and likely to invite application of the policy. We have seen nothing to change our previously articulated view in last year's memo that this policy does not serve a cognizable public interest goal, but we do not expect any dampening of the SEC's enthusiasm for it.

Whistleblower reports, which reached an all-time high last year at a staggering 76% increase over the previous year, increased yet again in 2022. The number of total whistleblower reports submitted to the SEC hit a new record high of 12,322 tips this year. While the year-over-year increase was small, it showed that the sharp jump in 2021 was not aberrational. The SEC paid a total of $229 million in whistleblower awards in 2022, which was the second highest in any year since the program's inception.

The SEC had a largely successful year in court, at least at the trial level. The Commission prevailed in 12 of the 15 cases it took to trial. In addition, the Commission found success in two noteworthy litigated enforcement actions that we highlighted last year. In *SEC* v. *Panuwat*, the first-ever enforcement action based on the "shadow" theory of insider trading, the Northern District of California denied the defendant's motion to dismiss despite acknowledging that the SEC's theory of liability was "unique." In *SEC* v. *AT&T*, AT&T agreed to settle the case for $6.25 million, the largest penalty ever imposed in a Regulation FD case, following the Southern District of New York's denial of cross motions for summary judgment.

By contrast, the SEC is facing serious setbacks in appellate litigation with respect to one of its two enforcement mechanisms, administrative proceedings before administrative law judges. In *Jarkesy* v. *SEC*, a Fifth Circuit panel concluded that proceedings before administrative law judges are unconstitutional, and vacated the SEC's finding that the respondents had committed securities fraud. In October 2022, the Fifth Circuit denied the SEC's petition for rehearing *en banc*, and the SEC has not petitioned for review by the Supreme Court. A second case in this area, *SEC* v. *Cochran*, is already pending before the Supreme Court, but will likely resolve only the procedural question of whether a respondent can challenge SEC administrative proceedings while awaiting a decision on the merits—a question the *en banc* Fifth Circuit answered in the affirmative. Neither *Jarkesy* nor *Cochran* of course affects the SEC's ability to bring enforcement actions in federal district court.

Some of the Commission's recent rulemaking also has enforcement implications. In October 2022, the SEC approved final rules which require listed companies to implement clawback policies authorizing recovery by a company of incentive-based compensation paid to current or former executive officers during the three prior completed fiscal years if the company restates its financials, regardless of whether there was any misconduct or failure of oversight on

the part of the individual executive officer. In December 2022, the SEC adopted amendments to the Rule 10b5-1 affirmative defense to insider trading liability. The new rule imposes mandatory cooling-off periods, restricts the use of multiple overlapping trading plans, limits the ability to rely on the affirmative defense for single-trade plans, and imposes new disclosure requirements.

The SEC's proposed rules regarding disclosures concerning ESG issues for public companies and investment advisers are still pending. In the event that new rules are ultimately adopted, we can expect heightened enforcement focus in this area. Indeed, the Commission's enforcement staff has not waited for new rules to pursue a variety of investigations in this realm. The cases brought thus far have involved either investment advisers that have not adhered to their disclosures concerning their use of ESG principles in making investment decisions, or companies in environmentally sensitive industries (such as mining) charged with making misleading disclosures regarding significant environmental harms arising from their business operations.

Cybersecurity

In 2021, the Biden administration declared cyber threats a "top priority and essential to national and economic security." This past year has seen that priority translated into concrete regulatory action. In March, the President signed into law the Cyber Incident Reporting for Critical Infrastructure Act of 2022 (CIRCIA). CIRCIA requires critical infrastructure companies—defined broadly—to report cyber incidents and ransomware payments to the Cybersecurity and Infrastructure Security Agency (CISA). It also requires CISA to promulgate rules implementing the new reporting requirements. In September 2022, CISA issued a Request for Information seeking public input on that project, and we should see some of the fruits of CISA's work in 2023.

Meanwhile, the SEC, which has been active in the cybersecurity realm for over a decade, ramped up its own regulatory efforts with two sets of proposed new cybersecurity-related rules for public companies and for registered investment advisers and funds, respectively. The proposed rules for public companies would require them to disclose cybersecurity incidents more often and with greater specificity; describe their cybersecurity policies, procedures, and governance, including whether and how cybersecurity risks are factored into business strategy and addressed by the board; and report on board members' and management's cybersecurity expertise. The rules for registered investment advisers and funds similarly address cybersecurity incident disclosure and policies and procedures, though they add recordkeeping requirements. Final forms of both sets of proposed rules are expected to issue this spring.

The SEC has also been active on the enforcement side of cybersecurity. Signaling its growing focus on protecting investors from cyber-related threats, the Commission announced in May 2022 that it would double the size of its Crypto Assets and Cyber Unit in the Division of Enforcement. And almost two years after the massive SolarWinds breach, following a lengthy and intensive campaign to gather information from public companies potentially affected by the breach, the SEC served a Wells notice on SolarWinds concerning its cybersecurity disclosures and internal controls and procedures.

Federal authorities are not the only players in this increasingly active field. In November 2022, for example, the New York Department of Financial Services announced proposed amendments to its cybersecurity regulation, originally promulgated in 2017, which would impose heftier cybersecurity-related obligations on financial services companies—including heightened cyber event notification requirements and expanded requirements for risk assessments.

Finally, in the related area of consumer data privacy and protection, 2022 saw the FTC continuing its aggressive enforcement efforts against companies that have failed to adequately safeguard consumer data. In October, the agency took action against online alcohol marketplace Drizly and education technology provider Chegg for their lax security practices that exposed the personal information of millions of their customers. The FTC orders against Drizly—and, notably, also against Drizly's CEO personally—and Chegg, which became final in January 2023, require the companies to limit future data collection and implement a comprehensive information security program.

Cryptoassets

The cryptoasset arena, already a priority enforcement focus for multiple agencies, has confronted even more intense scrutiny since the November implosion of cryptoasset exchange FTX. December saw the sparely-worded but sweeping criminal charges against Sam Bankman-Fried and other former FTX executives—a prosecution of age-old alleged misconduct in a brand new environment. Along with criminal charges, FTX's former executives are facing companion civil enforcement actions by the SEC and CFTC. As this and other, less high-profile matters advance over the coming year, we expect to gain clarity not just about what transpired at FTX in the run-up to its collapse but also about how courts will apply the regulatory framework to cryptoassets and related businesses more generally.

The collapse of FTX was only the latest in a series of recent failures of major centralized cryptoasset-focused institutions, with retail-oriented lending platforms Celsius, BlockFi, and Voyager, and institutional lender Genesis all filing for bankruptcy. Celsius is the subject of investigations or enforcement proceedings by at least 40 states and the federal government relating to its decision to freeze account withdrawals in June 2022, and its founder has been sued for fraud by the New York Attorney General. BlockFi's failure followed its February 2022 settlement with the SEC on charges that it had violated securities laws when it failed to register the offers and sales of its retail crypto-lending product. And Genesis and cryptoasset exchange Gemini now face similar SEC charges of engaging in an unregistered offer and sale of securities to retail investors through a cryptoasset lending program.

The year saw other cryptoasset-focused businesses charged with outright fraud and theft. In February 2022, DOJ arrested the alleged perpetrators of the massive 2016 hack of cryptocurrency exchange Bitfinex, seizing over $3.6 billion worth of bitcoin. In June 2022, the Department announced criminal fraud charges in connection with a crypto-related Ponzi scheme and, separately, what appears to be the largest alleged NFT scheme charged to date. In a burgeoning effort to combat insider trading in the cryptoasset domain, the SEC brought charges against a former Coinbase employee and his associates, and the SDNY charged a former OpenSea employee with fraud and money laundering in connection with frontrunning in NFTs.

Meanwhile, in recent weeks, DOJ, the CFTC, and the SEC all brought actions against an individual who admitted to draining approximately $116 million worth of cryptoassets from a decentralized finance (DeFi) trading platform and publicly defended his actions on the theory that exploiting an identified flaw in open source code is a legitimate trading strategy.

Other enforcement actions in this space have stemmed from the "initial coin offering" wave of 2017-2018. The SEC, for example, recently imposed a springing penalty of up to $30.9 million against Bloom Protocol. A key legal question at the heart of many of these actions is whether sales of the subject cryptoassets constituted illegal securities offerings—an unsettled question first raised prominently in the ongoing *Ripple* litigation, which is now in its third year.

A relatively newer frontier involves nascent enforcement actions implicating decentralized software platforms and decentralized autonomous organizations (DAOs). As to the former, in August 2022, the Treasury Department sanctioned Tornado Cash, a virtual currency mixer that facilitates anonymous transactions, for processing over $7 billion of virtual currency transfers—including for malicious actors. The Tornado Cash sanction came on the heels of Treasury's earlier sanctioning of virtual currency mixer Blender.io, which was used by a North Korea-sponsored cyber hacking group. And concerning DAOs, in September 2022, the CFTC imposed a $250,000 penalty against the organizers of a DeFi protocol and a successor DAO, taking the position that individual members of the DAO could be subject to liability for having participated in token-based governance votes. Enforcement efforts by necessity play catchup to market developments, and in light of regulators' growing scrutiny of DeFi-related abuses, we anticipate more Treasury sanctions and SEC enforcement actions in this area.

One pressing question we expect to be the subject of ongoing discussion through 2023 involves the proper allocation of regulatory authority over cryptoasset-related activities. That question calls out for clarification and is garnering intensified lawmaker attention in the wake of FTX's collapse.

Antitrust Developments

In 2022, DOJ's Antitrust Division and the FTC carried forward their early promises to implement ever more aggressive policies in ever more aggressive ways. DOJ persisted, for example, in applying the antitrust laws to labor markets in novel ways. This untested approach encountered a series of early setbacks with acquittals in *United States* v. *Jindal* and *United States* v. *DaVita*, the first wage-fixing/no-poach cases to reach trial. Recently, however, DOJ was able to secure its first conviction in this area when a healthcare staffing company pled guilty for conspiring with a competitor to allocate employee nurses and fix their wages. And as we summarized earlier this year, the FTC and DOJ also ramped up their challenges to pending mergers—at times animated by novel theories of harm—which have yielded a few wins but also significant pushback from the courts.

Despite some setbacks, there is no sign that either agency will retreat from its aggressive enforcement stance. FTC Chair Lina Khan and Antitrust Division head Jonathan Kanter have both doubled down on their commitment to push the boundaries of antitrust law—particularly in areas where they perceive historical underenforcement. And in November, the

FTC adopted a broad new interpretation of its Section 5 authority to allow it to redress "unfair methods of competition" not reached by the Sherman or Clayton Acts. We saw the exercise of this expanded authority in January 2023, with the agency's first-ever lawsuits challenging contractual noncompete restrictions under Section 5. A day later, the agency proposed a controversial new rule banning noncompete clauses in labor contracts.

Meanwhile, consistent with the broader DOJ agenda, in April 2022 the Antitrust Division updated its flagship leniency program to impose new conditions on immunity. The program—which has remained largely unchanged since 1993—allows organizations that are first in the door and that cooperate fully to avoid criminal prosecution and related fines for antitrust violations. The revised program adds three requirements: the applicant must show that self-reporting was done "promptly"; remedial measures must go beyond restitution and include a root cause analysis; and the applicant must endeavor "to improve its compliance program to mitigate the risk of engaging in future illegal activity."

FCPA Enforcement

FCPA enforcement activity saw an uptick in 2022 from 2021, with DOJ and the SEC resolving a combined total of 12 corporate investigations—four of these by joint DOJ-SEC resolutions with the same companies. On the DOJ side, there were four three-year DPAs (one involving subsidiary guilty pleas), and one plea agreement. Financial penalty figures also rebounded from 2021's level, with DOJ and the SEC imposing a total of approximately $1.6 billion in FCPA-related penalties, disgorgement, and prejudgment interest—about $964 million after credits, including for amounts paid to foreign and other U.S. enforcement authorities. DOJ also issued two declinations under its FCPA Corporate Enforcement Policy. Corporate prosecutions aside, DOJ brought FCPA charges against 13 individuals in 2022—a continuation of a recent downward trend.

The statistics tell only part of the story, particularly because FCPA cases often take a long time to investigate and resolve. But the following insights and trends can be gleaned from the substance of the resolutions:

- ***Wide Variety of Bribery Schemes Captured.*** FCPA resolutions in 2022 involved corrupt payments with objectives that ran the gamut—from obtaining government contracts, to securing favorable tax audit results, to facilitating the passage of legislation, and even to procuring favorable court decisions. U.S. authorities charged with enforcing the FCPA plainly are not limiting their scope or focus.

- ***Independent Compliance Monitors.*** Although it resurrected the independent monitor as an accepted component of criminal resolutions, the Biden administration has thus far been judicious in deploying this tool. Only two of the five DOJ FCPA resolutions in 2022—*Glencore* (resolved by plea agreement) and *Stericycle* (a DPA case)—involved monitors. In each of those, DOJ acknowledged the corporation's remedial efforts but noted that compliance enhancements undertaken in light of the misconduct that gave rise to the charges had not yet been fully implemented and/or tested by the time of the resolution.

- ***Insistence on Strict Compliance with DPA/NPA Obligations.*** In a 2021 policy pronouncement, DOJ signaled it would crack down on less than scrupulous compliance with DPA/NPA obligations. True to that pronouncement, the Department in 2022 extended the terms of two FCPA-related DPA monitorships, in circumstances where a company fell short of its obligations. March 2022 saw the one-year extension of Russian telecommunications company MTS's 2019 DPA, based primarily on the company's need for additional time to fulfill compliance-related undertakings. Then, in December 2022, Swedish telecommunications company Ericsson agreed to its own one-year extension of a 2019 DPA-related monitorship after the company was found to have breached the DPA by failing to disclose relevant information both before and after DPA execution.

- ***Cooperation with International Enforcement Partners.*** Consistent with the Biden administration's December 2021 publication of its U.S. Strategy on Countering Corruption, all but one of the 2022 FCPA resolutions featured some form of international cooperation and/or related foreign enforcement proceedings. Foreign cooperation warranted special mention in connection with Swiss technology company ABB's DOJ-SEC resolution, which involved bribes to a high-ranking government official in South Africa to help secure government contracts. In announcing the DPA with ABB and the guilty pleas of two of its subsidiaries, DOJ touted the matter as the "first coordinated resolution with authorities in South Africa." Separately, discussing the September 2022 resolution with Brazil-based GOL Linhas Airlines involving bribes to secure favorable tax audits, DOJ emphasized its coordination with Brazilian authorities and that U.S. authorities had agreed as part of the resolution to credit payments GOL made to Brazil—a good cross-border example of DOJ's anti-piling-on policy in action.

- ***DOJ Corporate Enforcement Policy.*** The ABB resolution is illustrative for another reason: It evidences DOJ's willingness under its revised CEP to apply leniency even to "recidivists" that fail to self-disclose—provided certain plus factors, like extensive remediation and cooperation, are present. ABB had resolved FCPA-related charges with DOJ and the SEC on two prior occasions, in 2004 and 2010. The compliance program the company implemented in the wake of those run-ins caught the misconduct that formed the basis of the 2022 resolution. The company was planning to self-disclose, but then the media broke the story. In resolving the matter, DOJ required guilty pleas from two subsidiaries, but allowed ABB a DPA without a monitor in view of the strength of its compliance program, its intent to self-disclose, its extensive remediation, and what was described by a senior DOJ official as its "A+ cooperation."

Anti-Money Laundering (AML)

In mid-December 2022, DOJ and the SEC announced a major AML resolution with Denmark-based Danske Bank. The joint resolution required Danske to plead guilty to conspiracy to commit bank fraud and pay total penalties of $2.4 billion (less $1.08 billion in offsets and credits for payments to Danish authorities). As part of the resolution, Danske acknowledged that its Estonian operations lacked adequate AML controls and oversight, and that Danske Bank lied to U.S. banks about its AML controls, transaction monitoring, and high-risk customer base associated with its Estonian unit.

The *Danske* resolution provides another stark reminder of the importance of maintaining a robust AML compliance program, including, as DAG Monaco underscored, "at newly acquired or far-flung subsidiaries."

Other International Enforcement Developments

In October 2022, DOJ brought its first case charging corporate material support for terrorism. French global building materials manufacturer LaFarge and its Syrian subsidiary pled guilty to conspiracy to provide material support to U.S.-designated terrorist organizations the Islamic State of Iraq and al-Sham (ISIS) and al-Nusrah Front (ANF). As part of the resolution, LaFarge agreed to pay a penalty totaling around $778 million and admitted to making payments to ISIS and ANF in 2013 and 2014 to facilitate operation of a cement plant located in Northern Syria. The scheme yielded $70.3 million in revenue for LaFarge, and included a "revenue-sharing agreement" with ISIS that compensated the terrorist organization based on the volume of cement that the company was able to sell its customers.

Notably, LaFarge was acquired in 2015 by a competitor that failed to conduct pre- or post-acquisition due diligence of LaFarge's business operations in Syria. Here again, DOJ took the opportunity to emphasize the importance of investing in robust compliance. In announcing the DOJ's *LaFarge* resolution, DAG Monaco emphasized that this case sends a clear message to all companies, particularly those doing business in "high-risk environments," of the need for appropriately tailored pre-signing and post-closing due diligence in merger and acquisition transactions.

State AG Developments

We expect the high level of state AG activity that we predicted last year to persist across a variety of sectors in 2023 and to expand perhaps into some new areas of enforcement activity. The multi-billion dollar settlements resulting from vigorous prosecutions by state AGs—particularly in the opioid space—are likely to further incentivize state AGs to continue pursuing aggressive regulatory oversight and litigation. Some of the most noteworthy settlements in 2022 included a $26 billion landmark deal with Johnson & Johnson and the three largest U.S. drug distributors, which resolved more than 3,000 opioid-related lawsuits filed by 46 states and other local governments, and the massive opioid settlements with Walmart ($3.1 billion) in November and CVS and Walgreens ($10.7 billion) a month later.

In addition, two notable trends emerged in 2022, which we anticipate will only continue next year:

First, state AGs showed an increased focus on ESG policies, with contrasting stances toward the topic often dividing across partisan lines. For example, we saw Democratic state AGs actively pursue enforcement actions involving so-called "greenwashing" allegations, focusing special scrutiny on the plastics, petrochemical, and chemical manufacturing industries. In April 2022, the California AG launched a first-of-its-kind investigation into fossil fuel and petrochemical companies for their purported role in "perpetuating a myth that recycling can solve the plastics crisis," which so far has resulted in subpoenas against ExxonMobil Corp. and demand letters to six top plastic bag manufacturers. Relatedly, AGs from Massachusetts, North Carolina, and California filed separate lawsuits against numerous chemical manufacturers, alleging that they caused environmental contamination while deceptively advertising their products as safe. At the same time, Republican state AGs seized on novel theories of antitrust and consumer protection laws to launch investigations to challenge ESG initiatives, arguing that coordinated efforts by investor groups and others to pressure companies to reduce their greenhouse gas emissions represent "climate collusion." Most recently, in October 2022, the Missouri AG joined by 18 other state AGs served six major American banks with civil investigative demands seeking information related to the banks' membership in the United Nations' Net-Zero Banking Alliance and other climate-related initiatives. In addition, the West Virginia AG, who in June 2022 won a favorable ruling by the Supreme Court to curb the EPA's efforts to decrease power plants' greenhouse gas emissions, has publicly threatened to sue the SEC for its proposed ESG rules, and most recently led a 21-state coalition to file formal comments against the Commission's proposals.

Second, in the absence of federal legislation regulating data privacy and social media firms, we expect state AGs will continue to fill that vacuum by their increasingly aggressive pursuit of privacy and cybersecurity claims. In March 2022, a bipartisan coalition led by eight state AGs launched an investigation into TikTok, and, in December, the Indiana AG sued the social media company for allegedly deceiving users about China's access to their data and for exposing children to mature content despite marketing the app as appropriate for those 12 years and up. Settlement agreements like Google's $391.5 million settlement with 40 states—the largest ever multistate data privacy settlement—over allegedly unauthorized tracking will likely generate "pile-on" pressure for other states to launch similar actions. Further evidence that states are taking a more aggressive stance against technology companies came in December 2022, when a multistate coalition of AGs across 26 states and the District of Columbia filed an *amicus* brief with the U.S. Supreme Court in the *Gonzalez* v. *Google* case, urging the Court to interpret Section 230 of the Federal Communications Decency Act narrowly to limit the breadth of "publisher" immunity and ensure that technology companies are held accountable under state consumer protection laws for internet-related harms.

Conclusion

Over many years, we have seen both up- and down-cycles in the level and intensity of white-collar criminal and regulatory enforcement activity. We happen at the moment to be in an up-cycle, with more aggressive actions and policy pronouncements. While such up-cycles can sometimes prompt frustration with apparent governmental dogmatism on pet

enforcement issues, these periods also present useful opportunities. Well-managed companies can—and, in our view, should—use the government's heightened attention to compliance effectiveness and tone at the top to searchingly review their current systems and practices, assess whether new policies and/or added resources might be appropriate, and consider the examples presented by enforcement actions taken against other companies, especially those in one's own industry or sector, as offering possible lessons to be learned.

These up-cycles also present, in appropriate cases, opportunities to fight back. For example, when the government is pursuing an untested or questionable legal theory, is misapprehending the key underlying facts, or is failing to consider crucial, mitigating context, a more combative strategy may be called for. In those cases, the combination of thoughtful advance preparation by the subject company to strengthen its overall compliance regime, together with effective, sustained advocacy on the company's behalf, is in our long experience the key to eventual success.

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January 30, 2023

Caremark: It's Not Just for Boards Anymore

The Delaware Court of Chancery last week held that corporate officers may be held liable for breach of "the duty of oversight." *In re McDonald's Corp. S'holder Derivative Litig.*, C.A. No. 2021-0324-JTL (Del. Ch. Jan. 25, 2023). Never before had oversight claims been applied to officers rather than directors.

At issue were allegations that McDonald's chief human resources officer was answerable in fiduciary breach for having failed to properly respond to evidence of sexual harassment at the company. The court had little trouble sustaining those claims in light of allegations that the officer himself had engaged multiple times in sexual harassment of employees. More generally, the court ruled that officers, like directors, owe *Caremark* duties—the duty to implement appropriate corporate controls, and the duty to react when "red flags" indicate those controls are not working.

The ruling, while not compelled by precedent or logically inevitable, is unsurprising given previous decisions indicating that the duties of officers largely mirror the duties of directors. And the decision importantly suggests principles to limit the scope of officer-oversight claims. The court made clear that a *Caremark* claim can be based only on knowing, bad-faith breaches of the duty of loyalty, so that negligent or even grossly negligent oversight failures will not state a claim. The court also emphasized that an officer's oversight obligations will typically extend only to matters within the officer's sphere of responsibility.

Notwithstanding these limiting principles, corporate defendants should brace for a wave of officer-oversight litigation, as the plaintiffs' bar explores the boundaries of the new doctrine. *Caremark* litigation has been on the rise for several years. Last week's decision should be expected to accelerate that trend.

But as we have recently emphasized, boards have powerful tools at hand to prepare for such litigation before it happens. Those same tools—including company-calibrated risk-management protocols, innovative board committee architecture reflecting the company's risk profile, and faithful record-keeping—will continue to be the best preventive medicine at the board level. Similar bespoke solutions can and should now be addressed at the level of the officer corps, to ensure compliance with best practices and reduce litigation risk. With effective preparation, *Caremark* exposure remains entirely manageable.

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January 27, 2023

Update on ESG, Stakeholder Governance, and Corporate Purpose

As we previously described (most recently here and here), environmental, social, and governance (ESG) topics have become prominent (and polarized) political issues in recent months. In the two months since our last update, significant developments in the attack on ESG have occurred in a few areas, as illustrated in the examples set out below. In providing this update, we underscore that the public and political scrutiny of ESG must not dissuade directors and officers from confronting and addressing ESG risks — to the contrary, fiduciary duties and *Caremark* obligations require it, and the long-term value of the corporation depends on it.

Asset Managers, ESG Funds, and Proxy Advisory Firms. The major asset managers remained in the spotlight, with BlackRock in particular subject to continued criticism due to CEO Larry Fink's outspoken support for ESG. For example, Florida announced that it would begin divesting $2 billion worth of assets currently managed by BlackRock. Louisiana, Missouri, South Carolina, Arkansas, Utah, and West Virginia made similar announcements over the course of 2022. ESG funds have also been affected, suffering significant outflows in 2022 with more money flowing out of than into such funds for the first time in over a decade. Finally, the proxy advisory firms have become targets of the anti-ESG coalition, joining asset managers as a punching bag for opponents of so-called "woke" capitalist policies. In January 2023, 21 Republican attorneys general authored a letter to Institutional Shareholder Services and Glass Lewis, the two major proxy advisory firms in the United States, challenging whether their net-zero emissions policies are based on the financial interests of investment beneficiaries rather than on other social goals, and asserting that their boardroom diversity policies may violate contractual and fiduciary duties as well as state anti-discrimination laws.

Policy and Regulatory. Other developments occurred in the policy realm. Texas held a hearing to probe the ESG investment policies of BlackRock and other major asset managers — but notably excused scrutiny of Vanguard following its withdrawal from the Net Zero Asset Managers initiative. In Florida, Governor Ron DeSantis and the Trustees of the State Board of Administration (SBA) approved measures to separate Florida's investments from ESG, and Governor DeSantis also proposed legislation that would permanently prohibit SBA fund managers from considering ESG factors when investing the state's money. Other states are in various stages of similarly considering, introducing, and implementing anti-ESG regulations, including through state law, investment resolutions, and/or opinions of the attorney general or state treasurer. Additionally, updated European ESG regulatory guidance has resulted in widespread downgrades in the designations of ESG portfolio funds of many of Europe's top asset managers. Early January 2023 estimates indicate that at least $140 billion in portfolio funds were downgraded, reflecting concern about the unclear rules and potential legal exposure resulting from improper classification. Moreover, the European Banking Authority's quarterly risk assessment, published in January 2023, specifically highlighted challenges that banks face in relation to climate data availability and modeling techniques — noting that failure to meet stated climate disclosure commitments could translate into greater legal and reputational risks, in particular with respect to greenwashing.

Shareholder Activism. Anti-ESG shareholder activism is on the rise and will be an important trend to watch as the 2023 proxy season gets underway. It is likely that the number of anti-ESG proposals will increase relative to the number of such measures put to a vote in 2022 and that anti-ESG proponents will become more vocal and numerous, in part strengthened by the growing political backlash against ESG. Consider the growth of anti-ESG activists, epitomized by Strive Asset Management, a fund that was launched in May 2022 to take on the major U.S. asset managers and "restore the voices of everyday citizens." Strive has already approached at least four large U.S. companies (ExxonMobil, Disney, Chevron, and Home Depot) to demand that they undo certain ESG-related initiatives, and Strive recently launched its "ESG Transparency Campaign" encouraging everyday investors to question their financial advisors about whether they are invested in funds that voted in favor of racial equity audits, emissions reduction plans, or executive compensation tied to environmental and social goals.

These developments — attacking what various interests choose to impute to the "ESG" label — should not obscure the reality of the substantive risks and strategies underneath that label that must be factored into corporate decisionmaking. ESG, properly understood, simply refers to some of the risks and strategies that a company must carefully balance in seeking to achieve long-term, sustainable value. Regardless of one's political preferences, the inescapable reality is that ESG risks have long been considered by boards and management — along with all other material risks and issues (as we recently discussed here) — and must continue to be so considered in order to ensure the company's value over the long term. The complex stakeholder issues that companies face today are integral to corporate sustainability and responsible risk management, and if corporate fiduciaries were to ignore these topics it would ultimately wreak harm on long-term corporate value and, in turn, shareholder value. Addressing ESG and sustainability-related risks in the context of considering the interests of all relevant stakeholders is consistent with directors' fiduciary duty of care, as well as with the board's legal obligation under *Caremark* (which we recently addressed here) to implement and monitor systems to identify material risks and to address risks once identified.

In sum, it remains incumbent upon each board of directors to look beyond short-term shareholder profits, to seek long-term value creation by taking into account the interests of all stakeholders. Whether they are labeled as ESG or something else, each of the components of ESG represents risk factors and strategies that must be managed, along with all other material considerations, by companies in order to arrive at the outcome that best promotes sustainability over the long term. Recent anti-ESG rhetoric does not undermine stakeholder governance as the proper model of corporate purpose, nor does it undermine the right and duty of directors and management teams to consider stakeholder and ESG risks and strategies.

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January 26, 2023

ESG in 2023: Looking at the Year Ahead

While 2022 saw the rise of a vocal and politically charged anti-ESG movement, the coming year could prove to be a pivotal moment in the maturation of ESG discourse, disclosures and governance. The ongoing debate as to whether the integration of ESG-related considerations into investment decision-making and corporate strategy is merely "woke capitalism" will require companies and investors to confront the significant disinformation and disagreements surrounding what ESG means and the role it serves. Ultimately, the battles waged in boardrooms, legislatures and courts may bring much needed clarity to the role of ESG issues (and the role of management and boards) in creating and protecting shareholder value, particularly as companies continue to face myriad risks, including macroeconomic headwinds, geopolitical uncertainty, emerging nature and other resource-related threats, cybersecurity dangers, and competition for talent. Meanwhile, the alphabet soup of voluntary ESG disclosure frameworks looks set to further consolidate with the International Sustainability Standards Board (ISSB) expected to release global sustainability and climate reporting standards. Regulators are also moving ahead with mandatory disclosures: the U.S. Securities and Exchange Commission (SEC) is expected to release and/or finalize rules on climate, cybersecurity, human capital and board diversity, the European Sustainability Reporting Standards are expected to be finalized mid-year, and regulators in Australia, Canada, China, Hong Kong, India, Japan, and Singapore are also considering or mandating ESG-related disclosures. With inflows to ESG-oriented investment funds and products remaining robust throughout 2022 and outpacing investments that do not address ESG considerations, pressure and interest from investors, regulators and other stakeholders look set to continue in 2023 and be reflected in shareholder engagement, the coming proxy season, earnings and investor communications, and broader market discussions.

We set forth below some key trends and considerations for this year:

1. *The Anti-ESG Movement Will Force Companies and Investors to Crystalize What is ESG and Why it Matters*

In recent years, ESG has grown to accommodate a broad swath of interests ranging from climate activists to impact investors to institutional investors and active managers. ESG's nebulous boundaries, however, have made it a target of the anti-ESG movement which has questioned whether it is merely a manifestation of ideological interests. As we have noted previously, we view ESG to encapsulate the range of risks that all corporations must carefully balance, taking into account their specific circumstances, in seeking to achieve long-term, sustainable value. Oversight and management of material ESG-related considerations that may impact a company's performance and the creation and preservation of shareholder value lie squarely within the fiduciary duties of management and the board and are consistent with the board's obligations under *Caremark*. Materiality assessments conducted by companies in connection with voluntary reporting on ESG-related factors have already provided insight into issues likely to impact corporate performance as have risk factor disclosures in public filings. Forthcoming disclosures mandated by regulators will provide further clarity, including the quantification, of the scope and magnitude of such issues. Company reporting is being further supported by insurance data, which indicates that companies are finding it increasingly difficult and costly to obtain coverage for certain risks such as cybersecurity breaches, while 2022 saw

record insured losses for severe weather incidents. As states such as Florida, Texas, Arizona, Indiana, North Dakota, Louisiana and others move to limit the consideration of ESG factors in investment decision-making, questions will inevitably be raised as to whether the pension plan fiduciaries of such states are fulfilling their fiduciary duties, particularly when companies have determined certain ESG factors to be financially material. The same questions may also arise in connection with lawsuits that seek to prohibit asset managers and pension plan fiduciaries from considering ESG factors in their investment decisions and efforts to reverse corporate policies designed to address identified ESG-related concerns, including in response to shareholder-supported proposals. It is perhaps notable that several of the tabled or enacted anti-ESG investment legislations do not prohibit the consideration of ESG factors outright or the ability of pension plans to provide ESG-oriented investments, but rather focus on eliminating the consideration of "non-pecuniary" factors. How companies and investors choose to respond to the public and legal challenges to the consideration of ESG factors by companies and investors may prove pivotal in crystalizing its value and purpose and addressing the criticisms of the anti-ESG movement. Ultimately, whether the concept of "ESG" matters or survives this debate may be secondary to the ability of companies and investors to continue addressing the range of risks and opportunities—many of which have been conveniently grouped under the "ESG umbrella"—that confront them in today's economy.

2. *The Long-Awaited Moment of Global Disclosures is Here, But…*

This year will likely see the culmination of multi-year efforts to consolidate voluntary global ESG reporting frameworks. The International Sustainability Standards Board (ISSB) is expected to complete the consolidation of existing voluntary frameworks including the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD) into new sustainability and climate-reporting standards to be released in the first half of this year. The new standards (both drafts were released in March 2022) will include Scope 3 emissions (subject to certain safe harbor protections) and climate-related scenario analysis disclosures. Nature-related disclosures and standards drawn from the Taskforce on Nature-related Financial Disclosures (TNFD), which will be finalized in September 2023, will also be reflected in ISSB's forthcoming standards. While the ISSB frameworks are not legally binding until formally adopted by a jurisdiction, it is expected that the UK will adopt the standards and Australia and China are among the countries considering adoption. A number of large asset managers, including BlackRock, State Street and Vanguard, have also voiced general support for ISSB's proposed frameworks.

In parallel with the consolidation of voluntary global reporting, the SEC is expected to finalize its rulemaking on climate and cybersecurity disclosures and adopt new rules on human capital metrics and board diversity. These rules come after the European Union last year adopted the Corporate Sustainability Reporting Directive (CSRD), which will, among other things, require public and private non-European companies with qualifying EU subsidiaries and which meet certain net revenue thresholds to comply with the EU Sustainability Reporting Standards, which are expected to be adopted mid-year. While the disclosure requirements for non-European companies will not be required until 2028, they are currently expected to be more expansive than that proposed by the SEC, covering, among other things, Scope 3 emissions, pollution, water, resource usage and biodiversity. Importantly, the disclosure standards will also apply "double materiality," meaning that companies will need to disclose material impacts to both investors and

stakeholders—in contrast to the investor-centric materiality standard used by the SEC. Looking ahead, multinational companies will need to carefully manage such policy divergences to avoid creating confusion and potential litigation risks over its sustainability disclosures.

3. *Greenwashing and Fraud Risks Will Refocus Attention on Governance*

Last year saw several enforcement actions on misstatements and omissions made by companies and asset managers on sustainability-related disclosures. The SEC has already indicated that it plans to continue stepping up enforcement actions on greenwashing and has proposed amendments to enhance and modernize the Investment Company Act "Names Rule," which would require funds whose names suggest a focus on a particular type of investment (e.g., sustainability) to adopt a policy to invest at least 80% of the value of their assets in those investments. Regulators in the European Union have also proposed new consumer protection legislation designed to target greenwashing, requiring companies to provide evidence backing up their green claims. Activists have also begun taking matters into their own hands through public social media campaigns.

As companies prepare for more rigorous and expansive disclosures, care will need to be taken to ensure that ESG reporting, particularly disclosed metrics, are subject to a similar degree of internal oversight and controls as are applicable to financial reporting. For U.S. issuers, the new SEC rules may require a reassessment of the allocation of oversight responsibilities for ESG reporting at the board level, including whether the board committee(s) tasked with oversight on reporting have sufficient bandwidth and current knowledge of best practices and regulatory and market expectations. In the M&A context, closer attention to due diligence and post-transaction integration processes can help mitigate the spread of ESG-related risks among companies, particularly the identification of internal controls and reporting weaknesses that could create heightened risks of reputational, legal and financial losses.

4. *Emerging Resource Risks—Biodiversity and Water—Are Coming to the Fore*

As we recently noted, new nature-related risks are quickly gaining focus among investors and regulators. In particular, focus has accelerated on resource loss, particularly biodiversity loss. Investor and regulator efforts to address biodiversity loss—estimated to lead to a $2.7 trillion loss to global GDP annually by 2030—have accelerated since the COP 15 summit last year and will be reflected in new disclosure standards being finalized by the Global Reporting Initiative (GRI), TNFD, ISSB, and the Science Based Targets Network. Notably, the recently launched Nature Action 100 initiative, comprising institutional investors working in partnership with Ceres and other advocacy groups, may herald the start of a new wave of shareholder engagement echoing the approaches taken by Climate Action 100+.

Water resource management is another issue that is emerging as a consequence of ongoing focus on climate risks. Ceres, in partnership with the Netherlands government, launched the Valuing Water Initiative in August 2022 with 64 institutional investor signatories representing $9.8 trillion in assets under management. The initiative has set forth key expectations for issuers, including commitments to avoid negative impacts on water availability and water quality across the value chain and board oversight and public policy engagement aligned with sustainable water resource management. In March, the UN will host the UN Water Conference, the second such conference in 50 years. Like COP 15, the conference agenda will

seek "commitments, pledges and actions, across all our sectors, industries and interests, uniting nations, stakeholders and professionals" with a focus on "accelerated implementation and improved impact" in meeting Sustainable Development Goal 6 (Clean Water and Sanitation).

5. *Effective Cybersecurity Risk Management Will Demand More Expertise and Controls*

Cybersecurity risks will likely continue to escalate in 2023 fueled by growing geopolitical instability, remote work, innovations in artificial intelligence (AI) and machine learning, shortages in technical expertise and increasing regulatory and investor expectations, all of which has prompted many to regard cybersecurity as an ESG risk, rather than just a technology challenge. IBM's recent report on the costs of cybercrime reported a 13% surge in data breach costs from 2020 to 2022 alone. U.S. companies are bearing the brunt of the losses, with companies suffering losses on average of $9.44 million per incident, more than double the global average. A report by the National Association of Insurance Commissioners (NAIC) released late last year also highlighted significant increases in insurance premiums (direct written premiums increased 75.3% year over year) as well as growing hurdles in underwriting policies with insurers becoming increasingly cautious when examining a company's risk profile, including risks presented by third parties with whom they work and contract as well as the robustness of internal security controls and cyber-risk procedures. Just this past week, the World Economic Forum published a new report highlighting trends in cybersecurity risks in which it noted that "cyber leaders still struggle to clearly articulate the risk that cyber issues pose to their organizations in a language that their business counterparts fully understand and can act upon." The SEC's proposed cybersecurity rules set to be finalized this year will further probe into the robustness of strategies and controls designed to mitigate and respond to cyber threats as well as the role and expertise of management and the board in overseeing and managing the organization's cybersecurity risks. To that end, organizations will need to continue to evolve and improve their efforts to equip their boards with the knowledge and tools to properly oversee risks, build a security-focused culture and recruit and retain skilled cyber professionals.

6. *Human Capital Management and the Competition for Talent Will Remain a Long-Term Challenge*

While the Great Resignation appears to be petering out, the talent war does not yet appear to be over. Recent reductions in force among the largest companies belie a labor market that continues to remain relatively tight. With the Covid-19 pandemic easing into the rearview mirror, a key legacy impact will be felt in the workplace where norms have shifted dramatically and could determine how talent is won or lost. The advent of remote work has created new opportunities to access and retain talent, while also creating challenges for training and integrating new employees. Companies will also need to prepare for a new generation of employees who are entering the workforce with heightened priorities regarding corporate purpose and employee wellness and mental health. The skills companies require today are also rapidly changing, and perhaps faster than the current workforce is able to adequately accommodate: ongoing innovations in AI and machine learning will render many roles obsolete while creating new roles that may require hiring or upskilling of employees. And companies will also need to address existing DEI commitments and targets, including how to address the impacts of reductions in force on workforce demographics and targets.

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The coming year presents new challenges and opportunities in the evolution of ESG. A global reporting regime looks to finally come into place, albeit with transatlantic divergences that will need to be carefully managed. Increased regulatory efforts at addressing greenwashing may again refocus attention on governance. Meanwhile, multiplying risks will continue to increase the responsibilities of boards and management. As in previous years, ESG continues to evolve rapidly, sometimes taking unexpected turns. Perhaps the biggest surprise of 2023 may be how the anti-ESG movement's efforts to unwind the consideration of ESG factors by companies and investors ultimately end up providing much needed clarity on the purpose and value of addressing the myriad of risks and opportunities that have fallen under the broad ESG canopy.

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The attached article, Corporate Governance Update: ESG in 2023: Politics and Polemics, was published in the New York Law Journal on January 26, 2023

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Corporate Governance Update: ESG in 2023: Politics and Polemics

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ESG is poised to become a major element of nonfinancial reporting at the very moment that it is becoming highly controversial and politicized. New European Union rules regarding mandatory ESG reporting will affect public and private U.S. companies that meet certain EU-presence thresholds or—significantly—are part of the value chain of an entity that is required to make the mandatory disclosures. This development represents a significant departure from past practices and will reach much farther than many companies may have anticipated. In the United States, the Securities and Exchange Commission is on the verge of adopting climate-related disclosure rules, possibly heralding the start of increasingly onerous ESG reporting obligations. These regulatory developments are supported by many, though not all, institutional investors, and the extent of such support going forward is likely to influence the future direction of ESG disclosure.

Over the past year, an anti-ESG backlash has flourished in the United States, led by conservative politicians and investors. Florida governor Ron DeSantis summarized the thesis of the backlash in a recent statement: "Corporate power has increasingly been utilized to impose an ideological agenda on the American people through the perversion of financial investment priorities under the euphemistic banners of environmental, social, and corporate governance and diversity, inclusion, and equity." At the World Economic Forum summit in Davos last week, a number of executives expressed frustration and concern over the intensifying drama around ESG. Like it or not, however, executives and investors will have to contend with ESG controversies and disclosure obligations for the foreseeable future while staying focused on their strategic priorities. Proactive board oversight—of both ESG disclosure practices and ESG-related controversies—will be essential to managing companies' reputational risk strategy around ESG.

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Breaking Down the Acronym

The acronym ESG has become shorthand for corporate social responsibility, a nebulous concept with no clear limits. However, not all of its components are controversial. "Governance" has been a key element of corporate housekeeping and management for two decades, ever since high-profile corporate crises at the turn of the millennium spurred new legislation and regulations aimed at improving directorial oversight at public companies. The ideals of good governance are at this point fully integrated into corporate housekeeping (*i.e.*, maintaining good corporate "hygiene") and are, by and large, not controversial. Governance practices and policies have evolved to become so inextricable from day-to-day corporate management, in fact, that "governance" does not really belong in ESG as the acronym has come to be understood. For the most part, governance is handled separately from ESG as a matter of corporate organization.

"Environmental" issues are implicated in both corporate actions, on the one hand, and investment decisions, on the other. Generally speaking, the view that corporations should steward rather than exploit natural resources is at this point widely accepted. The current debates revolve largely around the questions of how much, if any, financial downside to shareholders is acceptable in order to pursue environmentally friendlier operations (and for fund managers, how much, if any, financial underperformance is acceptable or necessary in order to pursue a "green" investment strategy); and to what extent current scientific knowledge enables companies or investors to undertake applicable cost-benefit analyses. These are genuinely difficult questions with answers that will necessarily evolve over time. It is important that any regulatory action in this area preserves the latitude for corporate decisionmakers to adapt to changing facts and circumstances.

On the investing side, the avoidance by ESG fund managers of entire industries—based on a belief that these enterprises are inherently harmful to the environment regardless of how responsibly they are undertaken—has led to political backlash in states dependent on so-called "brown energy" sources. The state of Texas passed legislation in 2022 barring state retirement and investment funds from doing business with ten firms that "boycott" fossil fuels; BlackRock is on that list, along with some banks, investment firms, and funds. Reportedly, at least fifteen other states are considering similar legislation.

Social issues, filed under "S," are notoriously broad and vague and represent the ripest target for controversy. The "Social" of ESG has been defined to include workforce requirements and composition, labor issues, product and employee safety, employee compensation, human rights abuses in international supply chains, geopolitical factors, and societal trends relating to current events, such as anti-gun, anti-abortion, and anti-tobacco movements. Tesla founder Elon Musk offered a new definition recently when he tweeted, in response to the news that the World Economic Forum incorporates ESG criteria in its own investment strategy: "The S in ESG stands

for Satanic." While Musk has a flair for hyperbole, it is no coincidence that the "S" was the target of his ESG jibe. A concept as broad as "social issues" is susceptible to overuse and overreach, and it is this vulnerability that has caused most of the recent politicization and backlash to ESG as a concept. Musk's highly visible comments on ESG include tweets stating that "ESG is a scam" and that an ESG score merely "determines how compliant your business is with the leftist agenda." The association of ESG values with the political left has exacerbated the divisiveness of the substantive issues.

Political Backlash vs. ESG

In the past year, ESG has come under attack from red-state attorneys general, treasurers, comptrollers, and governors. A number of state officials have made a point of publicly repudiating ESG as antithetical to the best interests of their constituents. BlackRock, whose chief executive has been an outspoken proponent of ESG, has been a particular target: In 2022, states including Florida, Louisiana, Missouri, Arizona, and West Virginia withdrew billions of dollars in investment funds from under the management of BlackRock. Florida's chief financial officer described CEO Larry Fink's ESG goals as overly focused on "social engineering" and antithetical to the goal of maximizing financial returns for shareholders. The Arizona state treasurer said that in the view of Arizona's investment team, "BlackRock moved from a traditional asset manager to a political action committee [and] away from its fiduciary duty in general as an asset manager." Last August, Florida adopted a resolution requiring state pension fund investments to seek the highest return on investments, without consideration of "non-pecuniary factors" such as "social, political, or ideological interests." Other states may take similar actions.

Conservative lawmakers in Washington have also taken aim at asset managers over ESG issues. A December 2022 report published by the Republican senators on the banking committee blasted the "Big Three" asset managers—BlackRock, State Street, and Vanguard—for "proudly us[ing] the voting power gained from their investors' money to advance liberal social goals" and promoting "political movements unmoored from financial performance." The report raised the question of whether the Big Three should be able to continue to rely on the disclosure exceptions for passive investors in light of their active attempts to influence the businesses in which they invest. It included recommendations that Congress investigate the extent of the influence of the Big Three over portfolio companies and consider increasing the reporting obligations of passive investors. With the House of Representatives now under Republican control, it is likely that political scrutiny of ESG investing and corporate ESG practices will intensify over the next couple of years.

There are indications that the ESG backlash is having an impact. While investors' capital continues to flow into ESG funds, the high-profile withdrawals of state funds from BlackRock have garnered attention disproportionate to their financial impact on the behemoth asset manager. BlackRock has been obliged to publicly defend its investment philosophy and approach. Vanguard, for its part, announced in December

2022 that it was withdrawing from the Net Zero Asset Managers initiative, stating that its decision was consistent with a "singular goal to maximize [investors'] long term returns." Cynics criticized Vanguard's move as an empty gesture, but nevertheless it indicates that firms are becoming wary of being perceived as blindly following social trends rather than exercising independent judgment. For years, there appeared to be little downside for institutional investors in publicly embracing ESG, but that is no longer the case.

On the business side, there are also signs of a revolt against ESG in corporate strategy. Prominent conservative investor Vivek Ramaswamy has criticized Apple and Disney for taking controversial stances on social justice issues. In an open letter to Disney last September, he asked, "What risk-reward calculus justifies taking controversial political positions that risk derailing Disney's otherwise strong economic prospects by alienating a majority of your customer base?" And in an open letter to Apple, Ramaswamy objected to the company's decision to conduct a "racial equity audit," arguing that such audits are harmful to the companies that conduct them and that there is evidence that the "actual owners" of Apple stock—as opposed to "the institutions who claim to represent them"—do not support either racial equity audits or hiring practices based on race, sex, or political beliefs. Ramaswamy's Strive Asset Management recently announced its intention to target companies during the spring 2023 proxy season seeking to reverse previously approved shareholder proposals relating to ESG concerns.

New ESG Disclosures

Meanwhile, ESG disclosures are on the verge of becoming a significant obligation for corporations worldwide due to the European Union's recent adoption of the Corporate Sustainability Reporting Directive (CSRD). The CSRD covers all large EU companies (including EU subsidiaries of non-EU parent companies), nearly all companies that are listed on an EU market, and companies with significant business in the EU. Whereas prior EU non-financial disclosure requirements covered fewer than 12,000 companies, an estimated 50,000 companies will fall directly under the scope of the CSRD. Many more beyond that, including private and public companies outside the EU, will be drawn into the disclosure regime by virtue of being in the "value chain" of reporting firms and thereby becoming the subjects of reporting companies' due diligence obligations. Companies that are upstream and downstream from reporting entities will be obliged to complete ESG-related diligence questionnaires and will have to manage the disparate challenges arising from the diligence process, including board oversight, internal controls, and potential Regulation FD selective disclosure issues. Furthermore, reporting companies will be required to mitigate and account for any problematic practices conducted by entities in their value chains, regardless of whether they have any control over these third parties. The CSRD represents a far-reaching and fundamental change to the reporting landscape and is certain to affect a large number of U.S. enterprises.

In the United States, the SEC has ESG-related disclosure proposals currently pending, primarily addressing environmental issues. Additional proposals relating to human capital management and board diversity are anticipated in 2023. If implemented, these proposed rules will require corporations to spend significant time and effort to adapt and develop appropriate oversight and internal controls. While these proposed rules are less onerous for reporting companies than the obligations to be imposed by the CSRD, it is possible that they represent only the beginning of a new era in the regulation of ESG disclosures. Despite the growing political backlash in the United States, investor enthusiasm for ESG remains high. According to Kiplinger, 85 percent of investors today are interested in ESG financial products. And it is clear that trends toward increased data-gathering, disclosure, and corporate responsibility for entities in their value chains are gaining momentum globally. Boards will need to be proactive and develop oversight processes for the new reporting obligations. Directors should also pay close attention to the ongoing cultural and political conflicts relating to ESG. With high stakes on all sides, the level of reputational risk in this area is likely to increase for the foreseeable future.

January 26, 2023

Corporate Bankruptcy and Restructuring: 2022–2023

In 2022, mass torts and crypto dominated the bankruptcy scene. While Chapter 11 activity was otherwise relatively subdued, out-of-court restructurings accelerated as the year progressed, with companies turning to debt exchanges and other transactions to improve liquidity amidst challenging credit markets.

As we enter 2023, rising interest rates, inflation and the possibility of a recession will present challenges for borrowers, sponsors and investors alike. The response of market participants to a credit environment not seen in more than fifteen years – or, for many, in their professional lives – will be a storyline of 2023.

We discuss below some of last year's trends and developments and our expectations for the year ahead.

Mass Tort Bankruptcies

Many of the largest Chapter 11 cases commencing or continuing in 2022 involved mass torts, including *Aearo Technologies* (combat earplugs), *Purdue Pharma* (opioids), *Boy Scouts of America* (abuse claims), and Johnson & Johnson subsidiary *LTL Management* (talc).

As these cases show, Chapter 11 can be a powerful tool for companies beset by tort lawsuits, because it provides a forum in which to negotiate with claimants (including a representative for future claimants) on a global basis and a mechanism to bind holdouts. At the same time, recent and ongoing cases show that bankruptcy is no panacea. Mass tort debtors require broad claimant support to obtain finality, and the path to obtaining that support, even when achievable, can be protracted and expensive. In addition, even as more companies look to Chapter 11 to address otherwise intractable mass tort problems, courts have continued to grapple with fundamental issues presented by those cases, including whether and when the bankruptcy process can be used to resolve claims against non-debtor affiliates, and the validity of the so-called "Texas Two-Step" strategy.

Non-Debtor Releases

The Chapter 11 process is principally designed to allow the debtor to obtain a fresh start free of its own past liabilities. But in many cases it has also been used to resolve the related liabilities of non-debtors. In asbestos-related cases, the Bankruptcy Code addresses that issue explicitly: When 75% or more of affected claimants support a plan, the plan can channel asbestos claims related to a Chapter 11 debtor to a trust, even if the claims are (or would be) asserted against certain non-debtor affiliates.

Outside the asbestos context, where the statute is not so explicit, non-debtor releases remain the subject of intense dispute. Some courts have held that non-consensual releases of non-debtors are simply unauthorized. Other courts have permitted them in limited circumstances, including where the releases have broad creditor support and the released parties make major financial contributions to fund payments to tort claimants. In 2022, in the landmark *Boy Scouts of America* case, the Bankruptcy Court in Delaware approved a broadly supported Chapter 11 plan to resolve claims not only against the debtor but also against affiliated local councils and others that made significant financial contributions to a global settlement. The decision is on appeal.

The legality of non-debtor releases is also at issue in the *Purdue Pharma* case. In that case, the debtor negotiated a broad resolution with opioid claimants that included a broad release of claims against Purdue's shareholders, the Sackler family. The bankruptcy court approved the plan, including the Sackler releases. On appeal, however, the Southern District of New York issued a lengthy decision reversing the bankruptcy court and disapproving the nonconsensual releases. Purdue's further appeal remains pending. (Congressional interest in legislation curbing the use of non-debtor releases, which in 2021 prompted hearings concerning Purdue and other cases, for now seems to have abated.)

Separate and apart from the issue of non-debtor releases as part of a plan, courts have also struggled with requests by debtors to enjoin lawsuits against related non-debtor parties while the bankruptcy case is pending. There is significant precedent for such injunctions in cases where, among other things, the related party has indemnity rights against the debtor or shared assets such as joint insurance. In the *Aearo Technologies* case, however, an Indiana bankruptcy court recently denied an injunction request filed by a 3M debtor-subsidiary to enjoin prosecution of thousands of earplug-related suits against 3M. That decision is on appeal.

The So-Called "Texas Two-Step"

The filing of the *LTL Management* case in October 2021, through which Johnson & Johnson is seeking to resolve its talc-related liability, focused nationwide attention on the so-called "Texas Two-Step" strategy (given that label's wide adoption, it is used for convenience without any connotation).

A Texas Two-Step uses a provision of Texas corporate law permitting "divisional mergers," which allow a company to divide itself into multiple entities and to allocate assets and liabilities between those entities. The Texas Two-Step strategy allocates operating assets to one entity, while leaving the tort liabilities with the other. The entity with the tort liabilities then files for bankruptcy protection.

Companies have not, to date, attempted to use the Texas Two-Step to try to strand liabilities at a new company without assets to service the liabilities. Instead, in the *LTL Management* and the other Texas Two-Step cases, the Chapter 11 debtor has filed with the benefit of a "funding agreement" with the separate operating entity, through which the operating entity agreed to indemnify the debtor for its tort liabilities.

In the *LTL Management* case, claimant representatives sought to dismiss the Chapter 11 case as having been filed in "bad faith." They argued that the Texas Two-Step was an abuse of the bankruptcy process insofar as it allowed J&J's consumer business to address its liabilities in Chapter 11 without exposing all of its assets and ongoing business to court supervision, and insofar as it allowed a solvent business to avoid the tort system with respect to thousands of pending suits. In a ruling issued February 25, 2022, the bankruptcy court in New Jersey declined to dismiss the case, concluding that bankruptcy could provide a forum for global resolution of J&J's talc liabilities, and that the Texas Two-Step did not necessarily harm claimants given the funding agreement that was in place. An appeal to the Third Circuit remains pending.

The attractions of using Chapter 11 to resolve business mass tort problems, and the controversies over non-debtor releases, the Texas Two-Step and other distinct features of mass tort bankruptcies, can be expected to continue throughout 2023.

The Crypto Crash

The "crypto winter" that began with the collapse of so-called "stablecoin" Terra last spring has led to a deluge of crypto-related Chapter 11 filings. Over the last months, crypto players, including Celsius, BlockFi, Core Scientific, Genesis, Voyager, and, most prominently, FTX/Alameda, have all sought Chapter 11 relief. While the reasons for each crypto bankruptcy vary, all of the cases have presented novel questions of how Chapter 11 and its tools can – and whether they should – be applied to crypto-related businesses.

Since its inception, the cryptocurrency industry has largely functioned as an alternative financial ecosystem. Although predicated on a sweeping vision of decentralized finance, as the industry has grown, centralized crypto analogs for banks, brokerages and exchanges have all developed, but without comprehensive regulatory oversight. Of particular consequence, while there are well-established legislative regimes for liquidations of failed securities or commodities brokers (which are not eligible to be debtors under Chapter 11), there is no special state or federal legal procedure designed for a liquidation of a crypto company. Customers of centralized retail-oriented crypto-asset platforms also lack protections analogous to FDIC or SIPC insurance. Bankruptcy courts in crypto cases have thus found themselves with a lack of statutory guidance or judicial precedent to answer fundamental questions.

As a result, the crypto cases have been freewheeling. Unlike traditional bank and brokerage failure regimes, which require mandatory liquidation by an independent trustee or receiver, leaders of crypto enterprises have sought other outcomes, such as intact sale to other crypto companies. Bankruptcy courts have also been required to make rulings on whether crypto deposited by customers with crypto brokerages is the customers' property, or whether it is instead "property of the estate" created by the bankruptcy filing, leaving customers with general unsecured claims. In *Celsius*, the bankruptcy court held that most of the crypto deposited with Celsius was "property of the estate."

There are also open questions as to whether some crypto companies are even eligible for Chapter 11. The SEC and CFTC have alleged that several crypto players were in the business of brokering the sale of commodities or of unregistered securities. If adopted, such a characterization may imply that those businesses ought to be treated as stockbrokers or commodities brokers, potentially rendering them ineligible for Chapter 11 reorganization.

These are just a few of the issues that have arisen in the last few months. In the long run, we believe the recent crypto collapses may well increase momentum for a broader body of regulation for the crypto space, including a regime for failed crypto companies.

Liability Management Activity

In 2022, borrowers and creditors continued to work together to raise capital and manage liabilities outside of bankruptcy court. Some "liability management" transactions, including "uptier" transactions, have spawned litigation. But in spite of those disputes, the pace of such transactions has, if anything, continued to pick up.

Historically, each distinct class of creditors in a distressed situation tended to work together, with each class protecting its interests from the other. But high-profile liability management transactions in recent years have altered that dynamic. Today, informal subsets of debt-holders within a class often propose transactions that are not open to all creditors in their class, and in some cases offer those participating creditors an edge over those who do not participate.

One prominent form of this new wave of transactions is a "drop-down" transaction, in which a borrower uses flexibility within its debt documents to contribute assets to an "unrestricted subsidiary" not subject to existing liens or covenants. The unrestricted subsidiary then borrows from existing or new creditors and pledges the newly unencumbered assets. This type of transaction is sometimes coupled with an exchange offer where participating lenders are offered the opportunity to exchange existing debt for new debt at the unrestricted subsidiary, typically at a discount.

Another new form is an "uptier" transaction, where a subset of a company's existing lenders and the company amend the company's existing debt documents to permit the transaction, including by allowing existing liens to be subordinated to new debt, after which the participating lenders exchange their debt (again, typically at a discount) for new debt that is senior to the unexchanged debt held by others. This type of transaction is often coupled with new money financing provided by the participating lenders on a "superpriority" basis.

Some of these transactions have resulted in litigation. In *TPC Group*, a Delaware bankruptcy judge recently upheld a variant of an uptier transaction, holding that the loan documents permitted the company and the majority lenders to subordinate existing liens to permit new-money superpriority financing. By contrast, in *Boardriders*, a trial judge in the New York Commercial Division declined to dismiss a complaint challenging an uptier transaction, including on the basis that it allegedly violated an implied covenant of good faith and fair dealing. An appeal of *Boardriders* remains pending. Litigation in other "uptier" cases is also pending.

For borrowers facing financial challenges, these types of transactions can be effective tools to generate liquidity or to deleverage. As a result, the specific terms of the debt documents that relate to such transactions have become more critical than ever, and should be carefully reviewed by borrowers and lenders alike to understand the full menu of options that might be available. Lenders should be active, constructive and open-minded. For lenders, being a first mover, with a willingness to provide capital and to think creatively, may well be rewarded in the current environment.

Developments in Allowance of Make-Wholes and Post-Petition Interest

Bankruptcy practitioners and debt investors alike are familiar with the Bankruptcy Code rule that holders of unsecured claims cannot receive "unmatured interest," meaning that interest on unsecured debt stops accruing on the petition date. In high-profile cases decided in 2022, courts of appeals considered aspects of this rule, including whether it applies to payment of a "make-whole" premium (a payment owed by the borrower when the borrower repays debt prior to maturity) and whether an exception exists in the rare cases where the debtor is solvent.

In *Ultra Petroleum*, the debtor became "massively solvent" due to a sharp increase in natural gas prices while its case was pending. Unsecured bondholders sought payment of a make-whole premium and post-petition interest, arguing that the make-whole was a form of liquidated damages rather than unmatured interest, and that, in any event, a "solvent debtor exception" required payment of unmatured interest.

The Court of Appeals for the Fifth Circuit agreed with the unsecured bondholders, but only because of a "solvent debtor exception." The court held that

unsecured make-wholes should generally be disallowed as unmatured interest, given the economic reality that they are designed to approximate lost future interest. Nonetheless, the court agreed that solvent debtors have to pay unmatured interest, and therefore awarded both post-petition interest and the make-whole. The significant implication, however, is that – in much more common cases involving insolvent debtors – unsecured creditors' make-whole claims will be disallowed, at least in the Fifth Circuit.

The *Ultra* court also considered what interest rate is to be paid by solvent debtors after the petition date and concluded that the contract rate, rather than the (much lower) rate applicable to court judgments, was appropriate. Earlier in 2022, the Ninth Circuit reached substantially the same conclusion in *PG&E*, holding that the debtor, which was undisputedly solvent but had filed bankruptcy to address wildfire tort liabilities, had to pay post-petition interest to its unsecured creditors. Other courts, however, including the Delaware bankruptcy court in *Hertz*, have concluded that the federal judgment rate is the appropriate metric for a solvent debtor. An appeal of *Hertz* on this point remains pending.

Solvent debtors are the rare exception in Chapter 11, but as shown by cases such as *Ultra* and *PG&E*, they increasingly are seeking to take advantage of the Bankruptcy Code to address particular problems, including mass tort liabilities. The recent decisions discussed above show that courts, while allowing solvent debtors to use the tools of bankruptcy, have in many cases insisted that those debtors pay all contractual amounts owed to creditors, even if such amounts would not be payable by insolvent debtors.

Other Developments

Below are other developments we are monitoring as we head into 2023:

- *All eyes on reinstatement*. The rapid rise in interest rates has rendered the terms of many fixed-rated instruments well below-market. We expect Chapter 11 debtors to be increasingly tempted to seek to reinstate those agreements under section 1124 of the Bankruptcy Code. In the *Mallinckrodt* case, as an example, the debtors successfully reinstated their first-lien notes, defeating an argument for immediate payment of a make-whole premium triggered by the bankruptcy filing. An appeal of that ruling remains pending. Participants in the Chapter 11 process would be well-served to evaluate the opportunity for (in the case of debtors) and risk of (in the case of investors) reinstatement of company-favorable financing arrangements.

- *Rise of cooperation agreements?* Perhaps as a reaction to recent liability management transactions, in several recent situations, creditors reportedly banded together and signed cooperation agreements where they agreed not to

support a transaction with the borrower unless it met certain agreed procedural criteria (usually, that the transaction be agreed to by some majority of the group, and that it be offered to all group members on substantially the same terms). As liability management activity continues, we may see more of such agreements.

- *Return of Retail Bankruptcies.* Over the past two years, retail bankruptcies have been relatively few and far between, following a dramatic surge in the early days of the COVID-19 pandemic. However, the combined factors of consumers under pressure from inflation, retailers being overextended on inventory, and capital markets having significantly tightened, has dampened the outlook for stressed retailers. Last week's *Party City* filing may indicate a broader uptick in retail Chapter 11 cases in 2023.

* * *

As we look forward to 2023, we expect rising interest rates, inflationary pressure and economic uncertainty will coalesce to cause a marked increase in out-of-court and in-court restructuring activity. Coming after nearly a decade and a half of low rates and strong growth, this new environment will require thoughtful navigation by distressed borrowers and investors alike.

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January 23, 2023

Caremark Exposure—And What to Do About It

2022 set another record for lawsuits faulting boards of directors for failing to adequately oversee corporate operations, a third consecutive year of acceleration. Mounting evidence suggests the trend is here to stay. But here's some good news: there is much boards and managers can do to anticipate and thereby de-risk this exposure.

Corporate litigation when things go wrong is of course nothing new. When manufactured products prove to be harmful, or services prove defective, or customers are injured, the class action bar has always responded, demanding payment for alleged tort victims. And so after a 2015 listeria outbreak linked to Blue Bell Creameries' ice cream was linked to three deaths and infections in four states, substantial tort litigation ensued, successfully seeking compensation for the victims from Blue Bell.

In 2019, however, in a case arising from the same tragic facts, the Delaware Supreme Court approved a further avenue for broad-sweeping recovery: a derivative action brought by Blue Bell stockholders seeking damages from Blue Bell's directors for inadequately supervising the company's food safety program. Although the court invoked the traditional "duty to monitor" framework—often called the *Caremark* doctrine after the 1996 decision that conceived it—it reversed the trial court's order dismissing the claim and applied that framework in a way that appeared to liberalize it.

The plaintiffs' bar certainly saw it that way. *Caremark* claims spiked immediately and have continued to mount. As important, since the Blue Bell decision, the courts have sustained these claims far more frequently. *Caremark* claims previously survived a motion to dismiss only very rarely. Now one out of three survive motions to dismiss—acquiring enormous settlement value, without regard to the ultimate merits of the claim or the difficulty of showing any damages to stockholders. As a result, any announcement of adverse corporate news or regulatory exposure should now be expected to trigger not only tort claims from victims, but *Caremark* claims by stockholders.

But effective tools are available to boards to address this risk—both before and after bad news hits the headlines. One key is to ensure the company has an appropriate enterprise risk management and compliance program that is reviewed at the board level. Equally important is to ensure the company addresses "hot button" issues like consumer privacy, cybersecurity, and product, consumer, and employee safety. To manage firm-specific risks, the board should consider bespoke committee architecture and rapid response teams to address potential crises. Likewise essential is skillful engagement with early stockholder inquiries and swift consideration of procedural considerations before litigation commences.

Perhaps most critically: maintain a faithful written record of the board's risk-management efforts, crafted to be producible in litigation. That way, when the plaintiffs come calling, the directors will have a robust record demonstrating their attention to foreseeable risks and supplying a pathway to early dismissal of the claim.

William Savitt

January 19, 2023

DOJ Announces Revised Corporate Enforcement Policy

Out of the gate, the Biden Administration made it clear that for companies under DOJ scrutiny, leniency would come at a higher price than before and failures to self-disclose, cooperate fully, and remediate completely would be met with harsher treatment. Fifteen months after Deputy Attorney General Lisa Monaco delivered her announcement of this tough-on-corporate-crime approach, Criminal Division head Kenneth A. Polite, Jr. this week announced a revised Corporate Enforcement Policy (CEP) incorporating some of its central tenets.

The new CEP reflects DOJ's effort to widen the gulf between companies that go out of their way to assist the government in its mission and those that are less compliant, transparent, and cooperative. As AAG Polite explained, "[t]he revisions make clear that there will be very different outcomes for companies that do not self-disclose, meaningfully cooperate with our investigations, or remediate." In service of that aim, the revisions give prosecutors more carrots to dangle. For example, under the old CEP, a company thinking about self-disclosing might have opted not to if the misconduct it identified implicated executive management. That aggravating factor, a company might have reasoned, would foreclose the possibility of a declination. In response, the new CEP makes clear that declination remains an option even with an aggravating factor provided that the company (a) immediately self-discloses conduct caught by an effective compliance program, (b) engages in "extraordinary" cooperation, and (c) implements "extraordinary" remediation. More generally, the new CEP gives prosecutors greater flexibility to reward self-disclosure, cooperation, and remediation. One key here is that companies cannot wait for the problem to arise to keep the hope of a declination alive. Under the new CEP, a company must have an "effective compliance program" at the time the misconduct involving an aggravating factor occurs to be eligible for a declination.

As AAG Polite put it, the "number one goal" for DOJ is "individual accountability." "[W]hen companies come forward and cooperate," that gives the Department its best shot at rooting out and punishing bad actors. For our clients, the number one takeaway is that the value of an effective compliance program has never been greater. The thoughtful design, implementation, and periodic updating of a program tailored to the full scope of the underlying business's risks will best position a company to achieve the most favorable resolution of any investigation.

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January 17, 2023

The U.S. Antitrust Merger Enforcement Agenda

In 2022, leadership at the U.S. antitrust agencies—the Federal Trade Commission and the Antitrust Division of the Department of Justice—pursued an aggressive enforcement agenda, while advocating for procedural and substantive changes to the antitrust laws. In addition to focusing on mergers involving competing firms, the agencies investigated and challenged transactions implicating other theories of harm, including vertical and conglomerate theories, potential and nascent competition, and monopsony (particularly involving labor markets). Although certain industries such as technology and pharmaceuticals continued to attract legal and political scrutiny, the push for increased enforcement was by no means limited to those sectors.

In December 2022, Congress passed the Merger Modernization Act of 2022, which will significantly increase HSR filing fees and the antitrust agencies' available funding. Armed with more resources, 2023 may be a critical year for U.S. antitrust enforcers as they attempt to transform the antitrust laws through the courts and legislation, as well as indirectly through the adoption of new merger guidelines and informal and formal rulemakings.

Transacting parties should anticipate broad inquiries unrelated to consumer welfare, including those involving labor. While the extent to which these explorations will lead to legally supportable theories of harm remains unclear, they may add significant transaction costs and delay. In addition, as the agencies pursue less traditional theories of harm and are less willing to settle cases, transacting parties may choose to prepare for, and ultimately to litigate, an agency challenge. In 2022, the agencies' court records were mixed, with a number of notable losses in cases involving non-horizontal theories of harm and litigated fixes.

Agency Leadership Pursues Significant Policy Changes

Despite Lina Khan's appointment as FTC Chair in June 2021, the FTC lacked a Democratic majority until Alvaro Bedoya's confirmation in June 2022. Under Chair Khan's leadership, the new majority has empowered the FTC staff to pursue aggressive enforcement actions and policy changes. In November 2022, the FTC issued a new policy statement describing how it intends to enforce Section 5 of the FTC Act, which prohibits "unfair methods of competition." The policy statement focuses on "incipient threats to competitive conditions," including a series of transactions that "individually may not have violated the antitrust laws" and "acquisitions of a potential or nascent competitor." Last week, the FTC's Democratic majority relied on that expansive interpretation of Section 5 to support a controversial proposed rulemaking that would ban most employee non-compete agreements.

The FTC is not alone in pushing an aggressive enforcement agenda. Assistant Attorney General of the Antitrust Division Jonathan Kanter, who was confirmed in November 2021, onboarded new senior leadership with the goal of bringing more merger challenges. Since taking the helm, AAG Kanter has overseen seven merger challenges, including five through trial—a significant increase in litigated cases from prior administrations. The Antitrust Division is also newly focused on Section 8 of the Clayton Act, which prohibits most interlocking

directorates between competing companies. Although no enforcement action has been brought to date, the ongoing investigations have resulted in a number of publicly announced director resignations. We expect the Section 8 enforcement initiative will continue in 2023.

Both agencies have become less willing to accept remedies in merger reviews to settle competition concerns. AAG Kanter has publicly articulated a high bar for accepting parties' settlement proposals, and the Antitrust Division did not enter into any formal merger settlement in 2022, preferring instead to litigate cases or allow parties to resolve concerns without a formal consent decree under the Tunney Act. Although the FTC is more willing to settle merger cases, FTC consents in 2022 involved substantial divestitures and, in certain instances, onerous terms. In October 2021, a divided FTC announced a new policy that requires settling firms to obtain "prior approval" for all future acquisitions affecting the same or related relevant markets; in 2022, those provisions were included in about half of the FTC's merger settlements.

Merger Cases in 2022

Antitrust litigation at the FTC and Antitrust Division was very active in 2022, including several challenges raising non-horizontal theories of competitive harm. As we have previously reported here, here and here, the results have been mixed and demonstrate that federal courts may constrain and temper some of the agencies' progressive policy objectives.

Several 2021 FTC cases carried into 2022, including a challenge to a hospital merger (*Hackensack Meridian Health/Englewood Healthcare*), which the FTC won. The FTC also challenged three consummated transactions and one proposed merger before the FTC's administrative law judge ("ALJ"). In one of these proceedings, *NVIDIA/Arm,* which involved vertical theories of harm in a developing industry, the transacting parties abandoned the transaction soon after the Commission authorized a challenge. In two other ALJ proceedings—*Altria/JUUL* and *Illumina/GRAIL*—the FTC suffered rare losses in its own in-house court. *Altria/JUUL* involved a substantial minority investment and allegations that the investment had eliminated potential competition by Altria in the market for e-cigarettes. The ALJ concluded that the FTC failed to prove anticompetitive harm resulting from the transaction. In *Illumina/GRAIL*, the FTC alleged that Illumina would have the incentive and ability to impair entry by and deter innovation from rival firms. The ALJ concluded that the parties' proposed behavioral remedies, which included long-term supply agreements, adequately addressed the FTC's concerns. Both cases are now on appeal before the full Commission. In the last pending case from 2021 (*Axon/Safariland*), trial has been stayed pending an appeal to the U.S. Supreme Court on the question of whether federal district courts (as opposed to the courts of appeals) have the authority to evaluate constitutional challenges to the FTC's structure and procedures.

As for 2022 cases, the FTC filed three challenges to hospital system mergers in federal court, and in each case the parties abandoned their proposed deals shortly after suit was filed. The FTC brought three additional deal challenges: (1) *Lockheed/Aerojet*, a vertical defense industry case, in which the parties also abandoned the deal after an administrative complaint was filed; (2) *Meta/Within*, which remains pending and in which the FTC has focused on potential lost competition in a nascent market for virtual reality applications; and (3) *Microsoft/Activision*, which involves vertical theories of harm from the combination of a "high-

performance" gaming console and multi-game content library and cloud gaming subscription service provider with a developer and publisher of high-quality gaming content.

The Antitrust Division began 2022 with three pending merger challenges: (1) *U.S. Sugar/Imperial Sugar*, which alleged harm to the market for the production and sale of refined sugar to wholesale customers in the Southeast and Georgia; (2) *Penguin Random House/Simon & Schuster*, a monopsony case, which alleged harm to top-selling authors, not consumers; and (3) the proposed alliance between American Airlines and JetBlue, which the Division argues is tantamount to a merger. Of the pending 2021 cases, the DOJ lost one (*U.S. Sugar/Imperial Sugar*), won one (*Penguin Random House/Simon & Schuster*), and tried the third and is awaiting a court decision (*American Airlines/JetBlue*). In *U.S. Sugar/Imperial Sugar*, the parties prevailed by arguing that the government's geographic market definition was too narrow and did not reflect the commercial realities of the sugar industry. DOJ has appealed the *U.S. Sugar* judgment.

The DOJ brought four new federal court challenges in 2022: an alleged merger to monopoly, *Verzatec/Crane*, which the parties abandoned shortly after suit was filed; two which the DOJ lost—*Booz Allen/EverWatch* and *UnitedHealth/Change*; and *Assa Abloy/Spectrum*, which is scheduled for trial in April 2023. In *Booz Allen/EverWatch*, the court rejected the government's contention that competition for a single government contract constituted an appropriate relevant market, and in *UnitedHealth/Change*, the district court decision, which the DOJ has appealed, squarely rejected each of the DOJ's claims of horizontal and vertical competitive harm, particularly after accounting for the parties' proposed divestiture. As in *UnitedHealth/Change*, the parties in *Assa Abloy/Spectrum* have proposed a divestiture which they believe addresses the DOJ's alleged competitive concern for residential locks; the reviewing court will undoubtedly consider that remedy in evaluating the deal's competitive effects.

* * *

Transacting parties in strategic deals should anticipate and plan for searching inquiries and associated delays in U.S. antitrust reviews. More than ever, early engagement with counsel will best position dealmakers to navigate the evolving regulatory environment. Thoughtful and well-executed regulatory strategies will maximize the chances of a deal's successful closing.

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January 12, 2023

Compensation Season 2023

Economic volatility dominated the corporate landscape in 2022, with inflation and stock price declines making headlines throughout the year, while the labor market remained surprisingly resilient, reinforcing the scarcity and value of key talent. We identify below some of the fundamental themes that may shape company compensation decisions in 2023.

Last of the Dodd-Frank Act Regulations. More than a decade after the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC in 2022 adopted final regulations regarding pay versus performance disclosure and compensation clawbacks, marking the last of the compensation-related regulations borne of the 2008 financial crisis.

Pay versus Performance (PvP). The final rules require annual proxy disclosure of the relationship between executive compensation paid by a registrant and the registrant's financial performance. Specifically, registrants must provide a table disclosing itemized compensation amounts and financial performance measures for their five most recently completed fiscal years (with the five-year look back phased in during a transition period). Registrants must comply with the new disclosure requirements in proxy and information statements for fiscal years ending on or after December 16, 2022; *i.e.*, for the upcoming 2023 proxy season. For a detailed discussion of the final PvP rules, see our August 29, 2022 memorandum, "SEC Adopts Pay Versus Performance (PvP) Disclosure Rules."

Compensation Clawbacks. Under the final rules, an issuer must adopt a policy that requires it, in the event of an accounting restatement, to recover from current and former executive officers incentive compensation that would not have been earned based on the restated results. There is virtually no board discretion under the final rules. In addition to the requirement that issuers adopt a compensation recovery policy, the final rules require disclosure in an issuer's annual proxy statement if, during the prior fiscal year, either a triggering restatement occurred or any balance of excess incentive-based compensation was outstanding. Based on the timetable established by the Commission, the NYSE and Nasdaq are expected to adopt final listing standards within the next twelve months and issuers will have 60 days thereafter to comply. Now is the time to review existing clawback policies to assess alignment with the SEC requirements. For a detailed discussion of the final clawback rules, see our October 31, 2022 memorandum, "SEC Adopts Final Compensation Clawback Rules."

Proxy Advisors. Last November, ISS added to its list of problematic pay practices that may result in a negative say-on-pay recommendation "severance payments made when the termination is not clearly disclosed as involuntary." ISS has historically criticized payment of severance when ISS concludes (whether or not correctly) that the nature of a termination is not a severance qualifying event; the recent guidance raises the profile and significance of 8-K disclosure for NEO separations. Last December, Glass Lewis revised the threshold for the minimum percentage of a long-term incentive grant that should be performance-based from 33% to 50%, and indicated that it will raise concerns with executive pay programs where less than half of an executive's long-term incentive grant is subject to performance-based vesting conditions. Other than the aforementioned items, neither ISS nor Glass Lewis issued any

significant compensation-related policy updates for the 2023 proxy season, though both firms announced voting policy updates in a number of other key areas including board diversity. For a detailed discussion of these updates, see our December 6, 2022 memorandum, "ISS and Glass Lewis Issue Final 2023 U.S. Voting Policies."

Equity Award Considerations in a Reduced Stock Price Environment. Many issuers experienced significant stock price declines in 2022, especially in the tech sector. These declines should be taken into account by compensation committees as they consider 2023 annual equity grants. A reduction in market value will result in awards covering a larger number of shares and may put pressure on individual and aggregate share limits under a company's shareholder approved equity plan. If plan limits are insufficient to make ordinary course annual equity grants, companies may consider granting cash-settled awards outside of a shareholder-approved plan in the form of phantom equity or stock appreciation rights; however, cash-settled awards will result in variable, or "mark-to-market," accounting. Companies seeking approval for new equity plans or new share reserves at their annual meetings may also need to re-calibrate the size of their requests to reflect the reduced value of shares.

Golden Parachute Tax. M&A transactions may expose company employees to the 20% excise tax on golden parachute payments (Section 280G), including the value of equity awards that vest in a transaction and severance payments for executive terminations that occur in connection with an acquisition. The golden parachute tax may significantly reduce the value of compensation that an executive has earned (or will earn in connection with a transaction). Fortunately, it is possible to mitigate the negative impact of Section 280G. Properly implemented non-compete arrangements and acceleration of taxable compensation into the year prior to a transaction closing may eliminate or reduce the adverse effects of the golden parachute tax, though, as noted in our recent memorandum, "FTC Proposes Rule Prohibiting Non-Compete Clauses for Workers," there is substantial regulatory pressure to limit or eliminate non-competes. The sooner that a company understands the scope of any 280G issues, the longer it has to identify and implement solutions.

Preserving Human Capital. The market for key talent remains robust notwithstanding the economic volatility and inflationary environment. The risk of losing key talent is as high as ever. In a tight labor market with unprecedented flexibility regarding work location, the competition for talent remains intense and may require off-cycle retention awards, especially if downward pressure on stock prices has reduced the retentive value of outstanding equity awards.

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January 10, 2023

FTC Proposes Rule Prohibiting Non-Compete Clauses for Workers

On January 5, 2023, by a 3-1 vote, the Federal Trade Commission (FTC) issued a notice of proposed rulemaking that, if promulgated and upheld, would dramatically overhaul the law governing non-competition covenants across the United States by prohibiting employers from entering into, and requiring employers to rescind existing, non-compete clauses with workers (including employees and individual independent contractors). The regulation of non-competes historically has been the province of states, many of which have recently amended or are in the process of reviewing and amending their laws on the subject. This notice of proposed rulemaking follows the FTC's January 4 announcement of enforcement actions against three companies for imposing non-compete restrictions on workers that the FTC contends violate Section 5 of the Federal Trade Commission Act (FTCA). The FTC estimates that 30 million existing non-compete agreements, covering an estimated 20% of American workers, would be illegal if the proposed rule were to become effective.

The Proposed Rule. Under the proposed rule, entering into or maintaining a non-compete with a worker constitutes an unfair method of competition in violation of the FTCA. The term "worker" is defined broadly as natural persons who work, whether paid or unpaid, for an employer; it includes senior executives, highly paid and highly skilled workers, though the FTC has specifically requested comments as to whether different standards should apply to these types of workers and, if so, how such categories and standards should be defined. The ban would extend to non-disclosure agreements and non-solicitation covenants that effectively function as non-competes, and to any requirements that workers repay training costs not "reasonably related" to the costs incurred by the employer. The proposed rule would expressly preempt state law to the extent inconsistent with the rule, though any state law that provides greater protection to workers than under the rule would not be deemed to be inconsistent.

Limited Exemptions. Importantly, the proposed rule exempts non-competes entered into between business entities, including in the sale of a business or in connection with a joint venture. In addition, the proposed rule would exempt non-compete clauses entered into with a person who (1) is selling a business entity, disposing of all of the person's ownership interest in the business entity or selling all or substantially all of a business entity's operating assets and (2) is a substantial owner, member, or partner (defined as holding at least a 25% interest in the business entity).

Comment Period; Effective Date. The public may comment on the proposed rule for 60 days following publication in the Federal Register. Once the rule is finalized, it would become effective 60 days following publication of the final rule in the Federal Register, and employers would have 180 days after publication to comply with the final rule.

Potential Challenges. Questions have already been raised as to whether the FTC has overstepped its regulatory authority, including by the U.S. Chamber of Commerce and FTC Commissioner Christine S. Wilson. Challengers contend that the FTC lacks the authority to define what constitutes "unfair methods of competition" through rulemaking, and that the proposed rule constitutes, under the Supreme Court's recent jurisprudence, a "major question"

requiring clear congressional authorization that has not been granted to the FTC. The proposed rule may also be challenged under the non-delegation doctrine, which prevents Congress from delegating its legislative power to another branch of government, including independent agencies such as the FTC.

Key Implications.

Employment Arrangements. Employers should review existing employment arrangements and policies and consider alternative ways to protect their trade secrets and goodwill in the event that the proposed rule becomes effective, including ensuring that current confidentiality and trade secrets clauses are up to date and cover or are entered into with all necessary workers. In negotiating new or upcoming employment arrangements, employers should also consider whether changes to compensation design are appropriate in order to incentivize retention and loyalty, such as retention awards and/or longer vesting periods.

Sale of Business. In M&A transactions, it is not uncommon for acquirors to enter into non-compete agreements with the seller's key employees. While the notice of proposed rulemaking acknowledges the importance and fairness of non-compete agreements in this context, limiting exempt non-competes to workers who own 25% or more of the acquired business renders the exemption virtually nonexistent for workers of publicly traded companies and many other large businesses. Should the proposed rule become effective, acquirors of businesses from sellers for whom non-competes are not permitted may wish to consider alternative methods of protecting goodwill, such as entering into employment or consulting arrangements with key individuals, delaying payment of consideration to align post-closing incentives, or exploring alternative structures such as joint ventures or commercial partnerships.

Section 280G. A strategy used to mitigate or avoid the impact of Section 280G of the Internal Revenue Code, the golden parachute excise tax, is to reduce the "parachute payments" by the amount of reasonable compensation paid to an individual for refraining to perform services under a valid non-compete agreement. The current proposed rule would render this strategy unavailable with respect to all but major shareholders, significantly restricting Section 280G mitigation strategies.

* * *

Non-competition covenants have long been viewed by courts and legislatures as a potential restraint on trade, with enforceability varying widely by jurisdiction. Although any new FTC rule is unlikely to become effective for several months or longer, the FTC's efforts to curtail non-competes, whether through Section 5 rulemaking or otherwise, constitute a dramatic change to this area of law that warrant close and immediate attention by companies.

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January 10, 2023

Financing Year in Review: The Tide Turns

2022 brought a halt to a nearly unabated 12-year run of booming credit markets and "lower for longer" interest rates. Rampant inflation, fears of a recession over the horizon, and war in Europe, among other factors, led to a marked contraction in credit availability and a slowdown in deal-making across sectors and credit profiles. U.S. high-yield bond issuances were down approximately three quarters year-over-year – the lowest volume since 2008 – while newly minted leveraged loans fell nearly two-thirds from 2021 levels. Investment-grade bond issuances fared better, but were still down significantly, with new issuances falling roughly 20% year-over-year. At year end, the average price for leveraged loans was just over 92 cents on the dollar, down from 99 at the year's beginning. And high-yield bond prices fell significantly further – with an average price of 87 cents in December, down from 103 at start of the year. Average yields for single-B bonds rose from under 4.7% on the first trading day of the year to over 9.2% on the last, and average BBB bond yields more than doubled, from 2.7% to 5.8% over the same period.

Looking ahead to 2023, with risk-free rates and credit spreads still elevated and the credit, dealmaking, regulatory and geopolitical environments uncertain, corporate borrowers and sponsors will need to plan rigorously to succeed on levered acquisitions and spin-offs and important refinancings. Obtaining committed financing, in particular, will require both creativity and avoiding the urge to let the perfect become the enemy of the good.

Acquisition Financing Commitments: A Time of Challenge and Creativity

New commitment anxiety

The market and regulatory forces at play in 2022 came together to exact a particularly tough toll on acquisition financing. Over the course of the year, credit markets dramatically weakened and became more volatile. Meanwhile, antitrust regulators in the United States and around the world began scrutinizing M&A deals with new intensity and skepticism, leading to less predictable (and much longer) timelines between signing and closing of acquisitions and, in turn, requiring longer-duration financing commitments. These two factors had a compounding effect that led lenders to become more reticent to provide commitments and to demand greater economics and more onerous flex terms when they did. This makes perfect sense: underwriting lenders promise to provide debt on certain terms and at certain pricing at signing, even though the debt will not be syndicated and funded until the related acquisition actually closes. Longer lead times in falling, volatile markets equate to increased risk that must be compensated.

Case in point, the year's sharp credit selloff resulted in a series of "hung bridges"; that is, acquisition financing debt that was committed in the frothier markets of 2021 and early 2022 but that could not be syndicated or sold to the market by commitment banks without bearing steep losses when it came time to fund in mid- to- late 2022. By September, the volume of such unsold debt was estimated at over $80 billion. As a result, many traditional banks spent the second half of the year more focused on de-risking existing commitments than on providing new ones.

The results were clear – not only did debt issuance volumes plummet, but so did debt-dependent M&A, particularly private equity buyout activity, which was down approximately 25% by deal value for the year and over 50% for the second half of the year versus the same periods in 2021.

Existing commitment fidelity

As tough as the environment was for obtaining new commitments in 2022, one silver lining for borrowers and sellers was how dependable *existing* commitments proved to be in the face of hung bridges. In numerous major transactions, including the sales of Twitter, Nielsen, Citrix, and Tenneco, banks followed through on their commitments even when the syndicated markets failed to support the deals – notwithstanding the immediate negative impact of doing so on their own balance sheets. This demonstrated that well-drafted commitment papers – and financing-related provisions in acquisition agreements – remain fit for purpose, even when placed under immense pressure. As we highlighted in our 2020 memo, tight acquisition financing commitments – and financing certainty provisions in M&A agreements – require substantial attention and negotiation. In most scenarios, they end up being an unused insurance policy, but as many of the past year's largest deals demonstrated, they are invaluable when most needed.

Creative solutions

Despite the year's challenged debt markets, M&A acquirors – even those unwilling to pay the higher rates of the day – found creative ways to pursue new deals, deploying strategies that include the following:

- *Buy now, borrow later…* Financial buyers who got deals done in 2022 often exhibited significant flexibility – up to and including executing all-equity deals, such as KKR's buyout of April Group, while waiting for sunnier market conditions to swap in debt. Large equity commitments also appeared in strategic deals in 2022 – for instance, Cigna provided a $2.5 billion preferred equity investment to Walgreens affiliate VillageMD's $8.9 billion acquisition of Summit Health. And buyouts announced late in the year that did feature leverage often featured uncharacteristically large equity commitments.

- *…or keep existing target debt on the books?* Sponsors in 2022 also pursued bespoke deal structures and terms to allow targets' existing debt to stay in place post-transaction – for instance, by settling for bare-minority voting stakes with meaningful veto and board appointment rights in order to avoid tripping change-of-control defaults in targets' existing agreements.

- *Seller as bank.* Some sellers offered financing to prospective purchasers – for example, Global Payments has agreed to provide a substantial amount of first- and second-lien acquisition financing in connection with the pending sale of its Netspend consumer business to affiliates of Rev Partners and Searchlight Capital Partners.

- *Risk acceptance*. Given the pricing of commitments in 2022, some parties to acquisitions – such as those in the sale of Aerojet Rocketdyne to L3 Harris (a large investment grade strategic acquiror) and the take-private of Continental Resources by its then-majority shareholder (which closed within 45 days of signing) – decided to go without financing commitments altogether, accepting

financing risk in favor of retaining value. This approach is not for the faint of heart, and is most often available where all parties are confident in the acquiror's ability to obtain financing at reasonable rates in spite of volatile market conditions (such as where the buyer is a large investment grade strategic company), where the timeline from signing to closing is short (affording greater visibility into the financing markets) and where the seller is in a unique position to evaluate and take on this risk (such as where the seller is a sophisticated financial sponsor).

- *Risk allocation.* Parties can also allocate financing risks in creative ways: During a brief downturn of the credit markets in 2010, for example, PVH (then a high-yield issuer) agreed to close its purchase of Tommy Hilfiger from a large, sophisticated financial sponsor only if PVH obtained financing meeting minimum terms (including weighted average cost of capital) agreed between the parties in the acquisition agreement. It will be interesting to see whether such creativity returns in 2023 after the 12-year bull market.

Direct Lending's Continued Ascent

As unconstructive syndicated markets failed high-yield issuers in 2022, "direct lenders" partially filled the breach and reached their greatest prominence yet. As mentioned in our 2019 and 2021 memos, direct lending has been on an upward trajectory – the market is estimated to have roughly doubled over the past five years, to $1.4 trillion. Once limited to the middle market, direct lending played a role in many of 2022's largest leveraged buyouts, reportedly financing some or all of the debt in six of the ten largest announced LBOs of the year.

Direct lenders are by no means immune to the effects of the markets, and the pace of their commitments slowed significantly in the second half of the year. But we expect their ascent to continue over the coming years, as top players raise larger funds and become more capable of writing commitments as large as those provided by traditional money-center banks, and as large family offices and pension funds continue to get into the act. Banks themselves seem to agree, with major players like JPMorgan and Goldman Sachs expanding their own "direct lending" offerings.

In the near term, it will be interesting to see how direct lenders act and react if the real economy softens. For instance, will direct lenders step into a void and finance CCC-rated companies that CLOs, stuck with concentration limits, cannot? And when distressed borrowers seek consents from direct lenders for amendments to their debt documents in challenging circumstances, will direct lenders play hardball (à la sponsors), or take a more constructive approach (à la traditional banks)? In the longer term, we will watch to see whether the currently myriad direct lending players shake out into a less numerous group of much larger players, and how the competitive dynamics among direct lenders impact both terms and practices.

Lightning Round: Other Developments to Monitor

Each year sees the emergence of new developments in the financing markets, and 2022 was no exception. Below are several we are keeping our eyes on as we head into the new year:

- *Advantage to Investment Grade Issuers?* While debt markets slowed across the board in 2022, investment grade borrowers enjoyed considerably more favorable conditions than

leveraged borrowers in terms of both economics and credit availability. It will be interesting to see whether investment grade strategic would-be-buyers – particularly those that are willing (and able) to add balance sheet cash to the mix – will fare better vis-à-vis sponsors in competitive acquisition processes in the current rate environment than they have over the last decade.

- *Buybacks to the future*. A substantial amount of corporate debt is currently trading at steep discounts, and not just hung bridge loans. Many issuers with financial wherewithal have begun to explore repurchasing this debt at prevailing (below-par) market prices, a trend last seen *en masse* (with respect to bond debt) in the wake of the 2008 financial crisis. But unlike loans originated prior to 2008, many modern bank loans (in addition to bonds) include technology that permits the issuer to repurchase such debt; borrowers with cash on hand and debt trading at a discount should read those provisions carefully and consult their advisors (including their tax advisors) so they can stand ready to pull the trigger if the math works.

- *Underwater convertibles*. Many companies – particularly in the technology sector – issued convertible notes with low coupons and short-dated maturities in 2020 and 2021 to increase cash-on-hand in the wake of the Covid-19 pandemic (or simply to obtain cheap money). As equity values have plummeted and credit markets have flagged, many of these convertible notes are now deeply out of the money, and trading at considerable discounts. An open question for the coming years is whether and how these convertibles will be refinanced: if they are refinanced with new convertibles, such instruments will be highly dilutive to then-existing equity holders; if they are refinanced with regular-way debt, the company's interest burden may become untenable.

- *A new threshold for "sacred rights"?* In the U.S. market, amendments to the most "sacred" terms of debt documents (such as principal amount, interest rate, and maturity date) typically require the unanimous consent of all affected lenders. In last year's memo, we suggested it was time to look to the U.K. practice of replacing this requirement for unanimous consent with high supermajority consent thresholds for "sacred rights" amendments. This year, we saw such technology trickle into the U.S. debt markets. We welcome this development and believe greater adoption would benefit both borrowers and lenders by facilitating consensual workouts and amendments and averting "holdout" problems.

- *Time to kill the ECF sweep?* Leveraged loans in the U.S. typically require the borrower to apply some portion of its "excess cash flow" to prepay the loan (commonly called an "ECF sweep"). We think it's time for the bell to toll on this provision. In good times, mandatory pay-downs are barely desirable for lenders (few lenders want their capital to dribble back, only to have to find ways to redeploy it). And when a borrower faces challenges and such a prepay might be valued, the modern ECF sweep provision, with a pages-long suite of deducts and exceptions, rarely results in a calculation requiring the borrower to repay any debt at all. As a result, in many deals, the ECF sweep amounts to many heavily negotiated pages of little practical substance. We think market participants should consider saving a tree and chopping the ECF sweep out from the U.S. credit markets.

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We enter 2023 facing known challenges and considerable uncertainty in the financing markets; but no matter what the new year brings, borrowers who remain informed, flexible, and creative will be well-positioned to make sound financing decisions.

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Cross-Border M&A – 2023 Checklist for Successful Acquisitions in the United States

After a record-shattering year for M&A in 2021, a crescendo that built over a decade, powered by unique pandemic conditions, 2022 was, statistically, a reversion to the mean. Worldwide M&A volume was $3.6 trillion in 2022, as against $6.2 trillion in 2021 and an average of $4.3 trillion annually over the prior ten years (in 2022 dollars). Average, however, 2022 was anything but. Russia's invasion of Ukraine sparked the largest armed conflict in Europe since World War II, creating a mass humanitarian crisis in Ukraine and the region, multiplying food and energy insecurity around the world, and exacerbating unresolved supply chain disruption caused by the coronavirus pandemic. Fiscal stimulus and adaptive monetary policies that supported growth during pandemic lockdowns were followed by inflation and hawkish policy responses, reversing a nearly 40-year trend of declining interest rates.

While M&A was not isolated from all of this upheaval, cross-border M&A continued to be attractive to dealmakers. Cross-border deals were 32% ($1.1 trillion) of global M&A in 2022, consistent with the average proportion over the prior ten years (35%). Acquisitions of U.S. companies by non-U.S. acquirors were $217 billion in transaction volume and represented 6% of 2022 global M&A volume and 19% of 2022 cross-border M&A volume. Canadian, British, Australian, Singaporean and Japanese acquirors accounted for 50% of the volume of cross-border acquisitions of U.S. targets, while acquirors from China, India and other emerging economies accounted for about 8%.

We expect cross-border transactions into the U.S. to continue to offer compelling opportunities in 2023. Transacting parties will do better if they are well-prepared for the cultural, political, regulatory and technical complexity inherent in cross-border deals. Advance preparation, strategic implementation and deal structures calibrated to likely concerns are critically important. Now, more than ever, thoughtful regulatory strategy and creative financing approaches deserve special focus.

The following is our updated checklist of matters that should be carefully considered in advance of an acquisition or strategic investment in the U.S. Because each cross-border deal is unique, the relative significance of the issues discussed below will depend upon the specific facts, circumstances and dynamics of each particular situation. There is no one-size-fits-all roadmap to success.

- *Political and Regulatory Considerations*. A high percentage of investment into the U.S. will be well-received and not politicized. However, a variety of global economic fault lines continue to make it critically important that prospective non-U.S. acquirors of U.S. businesses or assets undertake a thoughtful analysis of U.S. political and regulatory implications well in advance of any acquisition proposal or program. This is particularly so if the target company operates in a sensitive industry; if post-transaction business plans contemplate major changes in investment, employment or business strategy; or if the acquiror is sponsored or financed by a foreign government or organized in a jurisdiction where a high level of government involvement in business is generally

understood to exist. High-profile transactions may result in political scrutiny by federal, state and local officials. The likely concerns of government agencies, employees, customers, suppliers, communities and other interested parties should be thoroughly considered and, if possible, addressed before any acquisition or investment proposal becomes public. Anticipation of these concerns is especially important in light of the increasingly widespread acceptance in the U.S. of stakeholder governance and embrace of ESG (environmental, social and governance) principles by shareholders and companies alike. Planning for these issues is made all the more complex in the current political climate, in which debates about corporate purpose, stakeholder considerations and ESG factors in corporate decision-making have become politicized.

Similarly, potential regulatory hurdles require sophisticated advance planning. In addition to securities and antitrust regulations, acquisitions may be subject to CFIUS review, and acquisitions in regulated industries (*e.g.*, energy, public utilities, gaming, insurance, telecommunications and media, financial institutions, transportation and defense contracting) may be subject to an additional set of regulatory approvals. Regulation in these areas is often complex, and political opponents, reluctant targets and competitors may seize upon perceived weaknesses in an acquiror's ability to clear regulatory obstacles as a tactic to undermine a proposed transaction. Finally, depending on the industry involved, the type of transaction and the geographic distribution of the workforce, labor unions may well play an active role during the entirety of the process. Pre-announcement communications plans must take account of all of these interests. It is essential to implement a comprehensive communications strategy, focusing not only on public investors but also on all of these other core constituencies, prior to the announcement of a transaction, so that all of the relevant constituencies may be addressed with appropriately tailored messages. It will often be useful, if not essential, to involve experienced public relations advisors at an early stage when planning any potentially sensitive deal.

- *CFIUS*. The scope and impact of regulatory scrutiny of foreign investments in the U.S. by CFIUS has expanded significantly over the last decade, particularly following passage of the Foreign Investment Risk Review Modernization Act (FIRRMA) in 2018, and a series of implementing rules adopted by the U.S. Department of Treasury. As FIRRMA has been implemented, the role of CFIUS and the need to factor into deal analysis and planning the risks and timing of the CFIUS review process has been further heightened. Although notification of most transactions remains voluntary, FIRRMA introduced mandatory notification requirements for certain transactions, including investments in U.S. businesses associated with critical technologies, critical infrastructure, or sensitive personal data of U.S. citizens where a foreign government has a "substantial interest" (*e.g.*, 49% or more) in the acquiror. Critical technology and critical infrastructure are broad and flexible concepts, and FIRRMA expanded their scope to include "emerging and foundational technologies" used in computer storage, semiconductors and telecommunications equipment sectors and critical infrastructure in a variety of sectors. Supply chain vulnerabilities during the pandemic have also increased the likelihood that investments in U.S. healthcare, pharma, and biotech companies will be closely reviewed by CFIUS.

For example, as evidenced by CFIUS's opposition in 2021 to South Korean chip maker Magnachip Semiconductor Corp.'s merger with Wise Road Capital Ltd., a Chinese private equity firm, CFIUS will take an expansive view of its jurisdiction when semiconductor supply, even involving non-military applications, is at stake. CFIUS had "called in" the transaction for its review even though the transacting parties indicated that they had no U.S. nexus except for being incorporated in Delaware, having a Delaware subsidiary, and being listed on the NYSE, with any de minimis sales into the U.S. only occurring through third-party distributors and resellers. Magnachip's 2020 annual report, though, indicated that it had a facility in San Jose, California, which it used for "administration, sales and marketing and research development functions," that had been closed only in September 2020. A notable aspect of the deal was CFIUS's issuance on June 15, 2021 of an interim order preventing Wise Road from completing the acquisition of Magnachip pending its review of the transaction. While FIRRMA gave CFIUS the authority to prevent consummation of a transaction pending its review, CFIUS has so far rarely used that authority. In abandoning the transaction, Magnachip cited its inability to obtain CFIUS's approval for the merger. Companies operating overseas with even a limited nexus to the U.S. need to undertake CFIUS due diligence before engaging in a transaction in sectors that may involve core national security areas of interest.

Personal data is also a key area of scrutiny for CFIUS. Most recent enforcement actions involved concerns about Chinese investors' access to sensitive personal data of U.S. citizens. CFIUS enforcement in these sectors is likely to continue, as is a focus on domestic supply chain security to ensure that neither the U.S. nor its allies will be dependent on critical supplies from certain nations, including China. At the same time, the U.S. is likely to remain open to foreign investment, even in the national security sector. Most foreign investment will still be cleared, although it may get close review and possibly require mitigation actions, especially to the extent involving intellectual property, personal data, and cutting-edge or emerging technologies. While notification of a foreign investment to CFIUS remains largely voluntary, transactions that are not reviewed remain subject to potential CFIUS review in perpetuity.

Thus, conducting a risk assessment for inbound transactions or investment early in the process is prudent to determine whether the investment will require a mandatory filing or may attract CFIUS attention. Parties may wish to take advantage of the "declarations" process, which provides expedited review for transactions that present little or no significant risk to U.S. national security. Parties should also agree on their overall CFIUS strategy and consider the appropriate allocation of risk as well as timing considerations in light of possibly prolonged CFIUS review.

- *Antitrust Issues*. The U.S. antitrust enforcement agencies have had an aggressive enforcement agenda. Recently enacted federal legislation provides for significant increases in the budgets of these agencies. The scope of issues being reviewed in strategic transactions has expanded, and may result in delay and further efforts being required by the parties to get the deal cleared as quickly as possible. Although most enforcement continues to involve situations in which a non-U.S. acquiror directly or indirectly competes or holds an interest in a company that competes in the same industry as the target company, antitrust concerns may also arise if a non-U.S. acquiror operates

either in an upstream or downstream market of the target. In addition, a new law will require companies to disclose information regarding subsidies they receive from a "foreign entity of concern." Such foreign entities include, among other things, countries determined by the Secretary of Energy, in consultation with the Secretary of Defense and the Director of National Intelligence, "to be engaged in unauthorized conduct that is detrimental to the national security or foreign policy of the United States." China, Russia, Iran, and North Korea are among the countries currently identified as "foreign entities of concern." Pursuant to the new law, the federal antitrust agencies, in consultation with other government agencies, will promulgate rules that specify the information that affected parties must include in their HSR Forms and when such changes will take effect. Once effective, filing parties should expect increased scrutiny of any disclosed foreign subsidies, even if such subsidies are unrelated to the transaction being notified.

For a vast majority of transactions, the ultimate outcomes of transactions remain predictable and achievable without the need for remedies or litigation. Even in transactions that raise concerns, careful planning and a proactive approach to engagement with the agencies can facilitate getting the deal through.

For those transactions that raise antitrust concerns, parties should be prepared to deal with the U.S. antitrust agencies' strong preference for (1) divestitures in lieu of conduct remedies that require ongoing oversight to ensure compliance and (2) acquirors of the divestiture assets to be approved prior to closing rather than permitting divestiture acquirors to be identified by the parties and approved by the agency after closing. Also, the agencies have shown a greater willingness to refuse to engage in remedies discussions in some transactions, and transacting parties should be prepared to litigate, possibly with a remedy in place that resolves any concerns that the court may find justified. In all transactions, pre-closing integration efforts should be conducted with sensitivity to antitrust requirements that can be limiting. Home jurisdiction or other foreign competition laws may raise their own sets of issues that should be carefully analyzed with counsel.

- *Debt Financing*. After years of easy borrowing, 2022 brought a halt to "lower for longer" rates and booming credit. Global high-yield bond issuance volume cratered to less than a third of 2021 levels; investment-grade bond issuances fared better, but still fell 20% year-over-year. Leveraged loans also slowed significantly with volume falling to just 36% of 2021 levels.

  Challenging debt markets, which featured a substantial number of "hung bridges," sent some high-yield acquirors looking for acquisition financing alternatives, including by turning to "direct lenders" as a source of acquisition financing. Direct lenders played a major role in leveraged buyouts in particular in 2022, reportedly providing debt financing in six of the ten largest leveraged buyouts of the year globally. In other instances, buyers sought "seller financing" (a feature used in some carveout deals), or, in the case of some private equity buyers, increased their equity checks.

Looking ahead to 2023, with rates still elevated and the credit environment uncertain, corporate borrowers and sponsors will need to plan rigorously for financing-fueled acquisitions. Obtaining committed financing in particular will require both creativity and a willingness to not let the perfect be the enemy of the good-enough. Important questions to ask when considering a transaction that requires debt financing include: which financing market has the most favorable after-tax costs, how committed the financing is or should be (or *must* be by law, depending on the jurisdiction of the target); which lenders have the best understanding of the acquiror's and target's businesses (including both sector and locale); whether there are ways to share financing risk between a buyer and seller; and which banks or direct lenders are in the strongest position to provide acquisition financing commitments (and whether to seek financing from banks alone, direct lenders alone, or to speak with a mix thereof).

- *Transaction Structures*. Non-U.S. acquirors should consider a variety of potential transaction structures, particularly in strategically or politically sensitive transactions. Structures that may be helpful in sensitive situations to overcome potential political or regulatory resistance include no-governance and low-governance investments, minority positions or joint ventures, possibly with the right to increase ownership or governance rights over time; partnering with a U.S. company or management team or collaborating with a U.S. source of financing or co-investor (such as a private equity firm); utilizing a controlled or partly controlled U.S. acquisition vehicle, possibly with a board of directors having a substantial number of U.S. citizens and prominent U.S. citizens in high-profile roles; or implementing bespoke governance structures (such as a U.S. proxy board) with respect to specific sensitive subsidiaries or businesses of the target company. Use of debt or preferred securities (rather than common stock) should also be considered. Even seemingly more modest social issues, such as the name of the continuing enterprise and its corporate location or headquarters, or the choice of the nominal legal acquiror in a merger, can affect the perspective of government and labor officials.

- *Acquisition Currency*. Cash remains the predominant form of consideration in cross-border deals into the U.S., with all-cash transactions representing more than 64% by value of cross-border deals into the U.S. in 2022 (above the annual average of 55% over the prior five years). However, non-U.S. acquirors must think creatively about potential avenues for offering U.S. target shareholders a security that allows them to participate in the resulting global enterprise. For example, publicly listed acquirors may consider offering existing common stock or depositary receipts (*e.g.*, ADRs) or special securities (*e.g.*, contingent value rights). If U.S. target shareholders are to obtain a continuing interest in a surviving corporation that is not already publicly listed in the U.S., non-U.S. acquirors should expect heightened focus on the corporate governance and other ownership and structural arrangements of the non-U.S. acquiror, including as to the presence of any controlling or large shareholders, and heightened scrutiny placed on any *de facto* controllers or promoters. Creative structures, such as issuing non-voting stock or other special securities of a non-U.S. acquiror, may minimize or mitigate the issues raised by U.S. corporate governance concerns. Equity markets have never been more global, and investors' appetite for geographic diversity never greater; equity consideration, or an equity issuance to support a transaction, should be considered in appropriate circumstances.

- *M&A Practice*. It is essential to understand the custom and practice of U.S. M&A transactions. For instance, understanding when to respect—and when to challenge—a target's sale "process" may be critical. Knowing how and at what price level to enter the discussions will often determine the success or failure of a proposal; in some situations it is prudent to start with an offer on the low side, while in other situations offering a full price at the outset may be essential to achieving a negotiated deal and discouraging competitors, including those who might raise political or regulatory issues. In strategically or politically sensitive transactions, hostile maneuvers may be imprudent; in other cases, unsolicited pressure might be the only way to force a transaction. Takeover regulations in the U.S. differ in many significant respects from those in non-U.S. jurisdictions; for example, the mandatory bid concept common in Europe, India and other countries is not present in U.S. practice. Permissible deal protection structures, pricing requirements and defensive measures available to U.S. targets will also likely differ in meaningful ways from what non-U.S. acquirors are accustomed to in their home jurisdictions. Sensitivity must also be shown to the distinct contours of the target board's fiduciary duties and decision-making obligations under state law. Consideration also may need to be given to the concerns of the U.S. target's management team and employees critical to the success of the venture. Finally, often overlooked in cross-border situations is how subtle differences in language, communication expectations and the role of different transaction participants can affect transactions and discussions; preparation and engagement during a transaction must take this into account.

- *U.S. Board Practice and Custom*. Where the target is a U.S. public company, the customs and formalities surrounding board of director participation in the M&A process, including the participation of legal and financial advisors, the provision of customary fairness opinions and the inquiry and analysis surrounding the activities of the board and financial advisors, can be unfamiliar and potentially confusing to non-U.S. transaction participants and can lead to misunderstandings that threaten to upset delicate transaction negotiations. Non-U.S. participants must be well advised on the role of U.S. public company boards and the legal, regulatory and litigation framework and risks that can constrain or proscribe board or management action. These factors can impact both tactics and timing of M&A processes and the nature of communications with the target company.

- *Shareholder Approval*. Because most U.S. public companies do not have one or more controlling shareholders, public shareholder approval is typically a key consideration in U.S. transactions. Understanding in advance the roles of arbitrageurs, hedge funds, institutional investors, private equity funds, proxy voting advisors and other market players—and their likely views of the anticipated acquisition attempt as well as when they appear and disappear from the scene—can be pivotal to the success or failure of the transaction. These considerations may also influence certain of the substantive terms of the transaction documents. It is advisable to retain an experienced proxy solicitation firm well before the shareholder meeting to vote on the transaction (and sometimes prior to the announcement of a deal) to implement an effective strategy to obtain shareholder approval.

- *Litigation*. Shareholder litigation continues to accompany many transactions involving a U.S. public company but is generally no cause for concern. Excluding situations involving competing bids—where litigation may play a direct role in the contest—and going-private or other "conflict" transactions initiated by controlling shareholders or management—which form a separate category requiring special care and planning—there are very few examples of major acquisitions of U.S. public companies being blocked or even delayed due to shareholder litigation or of materially increased costs being imposed on arm's-length acquirors. In most cases, where a transaction has been properly planned and implemented with the benefit of appropriate legal and investment banking advice on both sides, such litigation can be dismissed or settled for relatively small amounts or non-financial "therapeutic" concessions. Sophisticated counsel can usually predict the likely range of litigation outcomes or settlement costs, which should be viewed as a cost of the deal.

  While careful planning can substantially reduce the risk of U.S. shareholder litigation, the reverse is also true: the conduct of the parties during negotiations, if not responsibly planned in light of background legal principles, can create an unattractive factual record that may both encourage shareholder litigation and provoke judicial rebuke, including significant monetary judgments. Sophisticated litigation counsel should be included in key stages of the deal negotiation process. In all cases, the acquiror, its directors and shareholders and offshore regulators should be conditioned in advance (to the extent possible) to expect litigation in the U.S. and not to view it as a sign of trouble. In addition, it is important to understand that the U.S. discovery process in litigation is different, and in some contexts more intrusive, than the process in other jurisdictions. Here again, planning is key to reducing the risk. Turning back a high-profile litigation campaign by the plaintiffs' bar, the New York courts recently made clear that deal-related fiduciary duty claims not arising under U.S. law should generally not proceed in the U.S. These rulings provide welcome comfort that U.S. courts will refuse to export their expansive discovery and procedural rules in the mine run of situations.

  The pandemic reinforced the importance of merger agreement provisions governing the choice of law and the choice of forum in the event of disputes between the parties—particularly disputes in which one party may seek to avoid the obligation to consummate the transaction. In *Travelport Ltd* v. *Wex*, for example, the English High Court interpreted the material adverse effect provisions of the parties' agreement under English law in a manner that surprised many U.S. observers. Similarly, in separate decisions examining whether and when a party can exit a merger agreement because the counterparty breached its interim operating covenants, the Superior Court of Justice in Ontario reached a different result than the Delaware courts. These disputes, reflecting the transactional disruption occasioned by the pandemic, have taught again an important lesson: cross-border transaction planners should consider the courts and laws that will address a potential dispute and consider with care whether to specify the remedies available for breach of the transaction documents and the mechanisms for obtaining or resisting such remedies.

- *Tax Considerations*. Understanding the U.S. and non-U.S. tax issues affecting target shareholders and the combined group is critical to structuring any cross-border

transaction. In transactions involving the receipt of acquiror stock, the identity of the acquiring entity must be considered carefully. Although some of the U.S. tax law changes enacted in 2017 (*e.g.*, reduced corporate income tax rate and introduction of a deduction for dividends received from non-U.S. subsidiaries) have ameliorated certain of the adverse tax consequences traditionally associated with being U.S.-parented, others remain or have been exacerbated (*e.g.*, continued application of "controlled foreign corporation" (CFC) rules to non-U.S. subsidiaries and expansion of such rules to provide for minimum taxation of CFC earnings (GILTI)). Where feasible, it often will be preferable from a U.S. tax perspective for the combined group to be non-U.S.-parented. In transactions involving an exchange of U.S. target stock for non-U.S. acquiror stock, the potential application of "anti-inversion" rules—which could render an otherwise tax-free transaction taxable to exchanging U.S. target shareholders and could result in significant adverse U.S. tax consequences to the combined group—must be evaluated carefully. Combining under a non-U.S. parent corporation frequently is feasible only where shareholders of the U.S. corporation are deemed to receive less than 60% of the stock of the non-U.S. parent corporation, as determined under complex computational rules.

The Inflation Reduction Act of 2022, enacted last August, introduced two new taxes effective for tax years beginning after December 31, 2022: (1) a 15% corporate alternative minimum tax (CAMT) on the "adjusted financial statement income" of certain large corporations and (2) a non-deductible 1% excise tax on certain stock buybacks. The CAMT generally applies to corporations with average annual adjusted financial statement income over a three-year period in excess of $1 billion (but a lower $100 million threshold applies to U.S. corporations that are members of a non-U.S.-parented group that satisfies the $1 billion threshold). By introducing a parallel set of tax rules—with broad regulatory authority for the Treasury Department to "carry out the purposes" of the new tax—the CAMT adds significant complexity for large taxpayers, and IRS guidance on many critical issues remains to be issued. While the CAMT shares certain features with the OECD's "Pillar 2" (which also would impose a 15% minimum tax on the book income of certain large multinational enterprises), numerous differences give rise to complex coordination issues. The new 1% excise tax on repurchases of stock of publicly traded corporations applies to a wide scope of transactions well beyond conventional stock buyback programs. For example, under recently issued IRS guidance, the excise tax would apply in all-cash acquisitions to the extent the consideration is paid with cash (including borrowing proceeds) of the U.S. target and would apply in "reorganizations" with respect to consideration received by the U.S. target's shareholders, other than acquiror stock or securities that can be received on a tax-free basis. In certain circumstances, the excise tax can apply to repurchases by publicly traded non-U.S. corporations (*e.g.*, if such corporation was the acquiring entity in an "inversion" transaction occurring after September 20, 2021 or if the repurchase is funded by a U.S. subsidiary).

Potential acquirors of U.S. target businesses should carefully model the anticipated tax rate of the combined business, taking into account the CAMT and any non-U.S. minimum taxes on book income, limitations on the deductibility of net interest expense and related-party payments, limitations on the utilization of net operating losses, as well

as the consequences of owning non-U.S. subsidiaries through an intermediate U.S. entity. Such modeling requires a detailed understanding of existing and planned related-party transactions and payments involving the combined group. In particular, the combination of the relatively low U.S. corporate income tax rate and limitations on the deductibility of interest expense have made it less attractive to "push" acquisition debt into a U.S. target group.

- *Employee Compensation and Benefits Matters*. In the acquisition of a U.S. target company, employee compensation and benefits arrangements require careful review as part of the diligence process and are often a key element of deal-related negotiations. Because both existing compensation arrangements and new arrangements that the target company seeks to implement in connection with a transaction may have a material impact on retention of target employees (and, therefore, the successful post-closing operation of the target's business) and may have significant associated costs, close coordination among the corporate development, finance, human resources and legal teams at the acquiror, the acquiror's investment bankers, and the acquiror's external transaction counsel is critical in order to ensure that all elements are properly accounted for in the valuation analysis, transaction terms, and integration plan.

  In particular, equity incentive compensation is an area that requires significant focus as it is highly utilized at U.S. companies and, though the practices vary depending on whether a company is publicly traded or privately held, the sector in which it operates, the size of its employee population, and other relevant factors, it would not be uncommon for equity awards to represent 10% or more of a company's fully diluted equity value and for such awards to be held by a substantial percentage of the employee population. Consequently, outstanding equity awards will need to be addressed at multiple stages of the deal process, including accounting for awards in the valuation analysis and purchase price negotiations, establishment of parameters for grants of incremental equity awards between signing and closing, and inclusion of provisions regarding treatment of all outstanding equity awards in the transaction agreement (which treatment must be consistent with the contractual terms of the awards).

  Additionally, acquirors should be mindful that, because U.S. employment laws are generally less prescriptive on compensation and benefit matters than the laws of many non-U.S. jurisdictions, some matters that are covered by applicable law outside the U.S. are generally negotiated on a bespoke basis in U.S. transactions. For example, it is customary in U.S. transaction agreements to include a covenant requiring that the acquiror maintain compensation and benefits for target company employees at specified levels (generally linked to either pre-closing levels or levels applicable to similarly situated acquiror employees) for a specified period of time following the closing (generally 12 months). While this covenant is not individually enforceable by target company employees as a contractual matter, it is a specific indication of the acquiror's intended treatment of target employees and, because the terms of the covenant are communicated to employees, a failure of the acquiror to comply with the covenant would have significant consequences both as to employee satisfaction and retention at the target company and more broadly for the acquiror's reputation when entering into future transactions. Another example is that, in the U.S., severance benefits are generally a

matter of contract rather than statute, and negotiation of specific severance protections for target employees—generally in the form of a commitment from the acquiror to maintain existing severance protections or to allow the target company to implement new or enhanced protections in advance of closing—is common.

- *Corporate Governance and Securities Law*. Current U.S. securities and corporate governance rules can be troublesome for non-U.S. acquirors who will be issuing securities that will become publicly traded in the U.S. as a result of an acquisition. SEC rules, the Sarbanes-Oxley and Dodd-Frank Acts and stock exchange requirements should be evaluated to ensure compatibility with home jurisdiction rules and to be certain that a non-U.S. acquiror will be able to comply. Rules relating to director independence, internal control reports and loans to officers and directors, among others, can frequently raise issues for non-U.S. companies listing in the U.S. Non-U.S. acquirors should also be mindful that U.S. securities regulations may apply to acquisitions and other business combination activities involving non-U.S. target companies with U.S. security holders.

- *Disclosure Obligations*. How and when an acquiror's interest in the target is publicly disclosed should be carefully controlled and considered, keeping in mind the various ownership thresholds that trigger mandatory disclosure on a Schedule 13D under the federal securities laws and under regulatory agency rules such as those of the Federal Reserve Board, the Federal Energy Regulatory Commission (FERC) and the Federal Communications Commission (FCC). While the Hart-Scott-Rodino Antitrust Improvements Act (HSR) does not require disclosure to the general public, the HSR rules do require disclosure to the target before relatively low ownership thresholds may be crossed. Non-U.S. acquirors should be mindful of disclosure norms and timing requirements relating to home jurisdiction requirements with respect to cross-border investment and acquisition activity. In many cases, the U.S. disclosure regime is subject to greater judgment and analysis than the strict requirements of other jurisdictions. Treatment of derivative securities and other pecuniary interests in a target other than common stock holdings can also vary by jurisdiction.

- *Due Diligence*. Wholesale application of the acquiror's domestic due diligence standards to the target's jurisdiction can cause delay, waste time and resources or result in missing a problem. Due diligence methods must take account of the target jurisdiction's legal regime and, particularly important in a competitive auction situation, local norms. Many due diligence requests are best channeled through legal or financial intermediaries as opposed to being made directly to the target company. Due diligence requests that appear to the target as particularly unusual or unreasonable (which occurs with some frequency in cross-border deals) can easily create friction or cause a bidder to lose credibility. Similarly, missing a significant local issue for lack of jurisdiction-specific knowledge or understanding of local practices can be highly problematic and costly. Prospective acquirors should also be familiar with the legal and regulatory context in the U.S. for diligence areas of increasing focus, including cybersecurity, data privacy and protection, Foreign Corrupt Practices Act (FCPA) compliance, and other matters. In some cases, a potential acquiror may wish to investigate obtaining representation and warranty insurance in connection with a potential transaction, which has been used with

increasing frequency as a tool to offset losses resulting from certain breaches of representations and warranties.

- *Distressed Acquisitions*. In a relatively quiet year for U.S. bankruptcy filings, the U.S. remained the forum of choice for cross-border restructurings. Although tighter fiscal and monetary policy and reductions in governmental support as the pandemic eased, along with rising inflation, negatively impacted many in industries such as aviation and energy that had held on or even thrived during the pandemic, Chapter 11 filings by large companies declined from 2021. The wave of filings in the cryptocurrency sector is the outlier, but it stems from its own anomalous causes. Nonetheless, some multinational companies continued in 2022 to take advantage of the debtor-friendly and highly developed body of reorganization laws, as well as the specialized bankruptcy courts, that have long made U.S. Chapter 11 bankruptcy filings attractive. Among the advantages of a U.S. bankruptcy are the expansive jurisdiction of the courts (such as a worldwide stay of actions against a debtor's property and liberal venue requirements); the ability of the debtor to maintain significant control over its normal business operations; relative predictability in outcomes; and the ability to bind holdouts to debt compromises supported by a majority of holders and two-thirds of the debt. In addition, companies exposed to potential mass tort liability now routinely invoke Chapter 11 in an effort to resolve all claims against the company in a single forum.

  U.S. bankruptcy courts generally permit the sale of substantial assets or of the whole company during, or in connection with emergence from, a Chapter 11 proceeding. Features of the Bankruptcy Code of particular importance to M&A transactions include the ability to obtain a sale order providing title to assets free-and-clear of all prior liabilities and liens on a worldwide basis, the ability to borrow on a super-senior basis to fund the company during and upon exit from bankruptcy, the ability to reject undesirable contracts and leases while keeping those desired by the buyer, and the easing of certain antitrust and securities regulatory burdens.

  Those evaluating a potential acquisition of a distressed target with a connection to the U.S. should consider the full array of tools that the U.S. bankruptcy process makes available. Those could include acquisition of the target's fulcrum debt tranches that are expected to be equitized through a restructuring, acting as a plan investor or sponsor in connection with a plan of reorganization, backstopping a plan-related rights offering, or participating as a bidder in a court-supervised "Section 363" auction of a debtor's assets. In addition, multinational companies facing potential mass tort liability should consider use of Chapter 11 for subsidiaries with a sufficient U.S. connection to protect a purchaser from the overhang of legacy liabilities.

  Transaction certainty is critical to a debtor and its stakeholders and thus to a potential acquiror's success in a distressed context. Accordingly, non-U.S. participants need to plan carefully (particularly with respect to transactions that might be subject to CFIUS review, as discussed above) to ensure that their bid will be considered on a level playing field with U.S. bidders. Acquirors must also be aware that there are numerous constituencies involved in a bankruptcy case that they will likely need to address (including bank lenders, bondholders, distressed-focused hedge funds and holders of

structured debt securities and credit default protection, as well as landlords and trade creditors), each with its own interests and often conflicting agendas, and that there exists an entire subculture of sophisticated investors, lawyers and financial advisors that must be navigated.

Various options are available to troubled companies seeking to take advantage of the U.S. bankruptcy laws. Multinational debtors often file bankruptcy petitions in the U.S. and link the confirmation or consummation of a plan of reorganization with successful administration of related foreign ancillary insolvency proceedings. Even when the principal proceeding takes place elsewhere, large non-U.S. companies can file cases under Chapter 15 of the U.S. Bankruptcy Code to obtain "recognition" of foreign insolvency proceedings in a U.S. bankruptcy court. The legal requirements for such recognition are minimal, and can include minor connections to the U.S. such as debt instruments with U.S. choice of law or venue provisions, or payment of a retainer to U.S. counsel. Recognition of a foreign proceeding under Chapter 15 facilitates restructurings and asset sales by providing debtors with many of the same protections that Chapter 11 provides from creditors in the U.S., and the ability to take control of and administer U.S. assets. Chapter 15 also provides the ability to bind U.S. creditors or holders of U.S. law debt to the terms of a restructuring plan implemented in a foreign proceeding, so long as the proceeding accords with broadly accepted principles of due process and creditors' rights.

- *Collaboration*. More so than ever in the face of current U.S. and global uncertainties, most obstacles to a deal are best addressed in partnership with local players whose interests are aligned with those of the non-U.S. acquiror. If possible, relationships with the target company's management and other local forces should be established well in advance so that political and other concerns can be addressed together, and so that all politicians, regulators and other stakeholders can be approached by the whole group in a consistent, collaborative and cooperative fashion.

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December 28, 2022

Expansive Guidance on One Percent Stock Buyback Tax Affects M&A

Yesterday, the Treasury Department and the Internal Revenue Service issued guidance (the "Notice") applying the recently enacted one percent excise tax (the "Excise Tax") on repurchases of stock of publicly traded corporations to a wide scope of transactions well beyond conventional stock buyback programs. Expansive application of the Excise Tax pursuant to the Notice will create a friction cost for many M&A transactions, especially those involving cash consideration. As discussed in our memo dated September 6, 2022, the Excise Tax applies to repurchases after December 31, 2022. No grandfathering exception applies for binding contracts entered into on or prior to that date.

Parties involved in transactions with publicly traded U.S. target corporations will need to consider how much of the merger consideration is subject to the Excise Tax and how that cost will be borne. Further, the Notice creates disparate consequences depending on whether the transaction is a tax-free "reorganization." Specifically, under the Notice:

Leveraged Buyouts and Other All-Cash Acquisitions. In an all-cash acquisition of a target corporation, merger consideration is subject to the Excise Tax to the extent paid using cash on the target's balance sheet or funded by proceeds of debt borrowed (or assumed) by the target, but merger consideration sourced at the acquiror is generally not subject to the Excise Tax.

"Boot" in a Reorganization. In contrast with the rule applicable to all-cash acquisitions, in a mixed stock/cash acquisition that qualifies as a tax-free reorganization, all cash "boot" paid to target shareholders is subject to the Excise Tax regardless of whether it is sourced at the target or the acquiror, a surprising and especially taxpayer-unfriendly conclusion. Cash paid in lieu of fractional shares is not subject to the Excise Tax nor is merger consideration in the form of acquiror corporation stock.

Apart from M&A transactions, the Notice confirms that tax-free "split-off" transactions (where the parent corporation exchanges shares of a subsidiary corporation for parent shares) are not subject to the Excise Tax to the extent that parent shareholders receive shares in the spun-off corporation.

Under the Notice, a redemption of preferred stock is subject to the Excise Tax, even if required by the terms of the instrument and whether or not the preferred stock is publicly traded. The Notice also clarifies that repurchases pursuant to an accelerated share repurchase program are subject to the Excise Tax when ownership of the repurchased shares is transferred from the investment bank to the issuing corporation.

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December 16, 2022

Nature as an Asset: The Coming Wave of "Natural Capital" and Biodiversity Shareholder Activism and Stewardship Pressure on Boards of Directors

As anticipated in our February 2021 memo, the terms "natural capital," "biodiversity," "nature loss," "ecosystem restoration" and the like have increasingly entered the investor and corporate lexicon. This has accelerated since the publication of The Economics of Biodiversity: The Dasgupta Review, the groundbreaking independent study commissioned by the U.K. Treasury which presented "Nature as an Asset" and was produced by Professor Sir Partha Dasgupta, Frank Ramsey Professor Emeritus of Economics at the University of Cambridge.

With natural capital depletion and biodiversity loss estimated to result in a decline in global GDP of $2.7 trillion annually by 2030, institutional investors are increasingly defining and grappling with these issues, forming organized coalitions, and deciding to press public companies for action, enhanced board oversight and new disclosures. These efforts have accelerated in recent weeks in the lead up to the COP15 summit and will be amplified by related reporting frameworks being finalized by the Global Reporting Initiative, the Taskforce on Nature-related Financial Disclosures, the International Sustainability Standards Board, and the Science Based Targets Network. How and whether to be "nature-positive" is also being explored by major corporations, investors and influential stakeholder groups.

For example, earlier this week, a coalition of institutional investors launched Nature Action 100, led by AXA Investment Managers, Columbia Threadneedle Investments, BNP Paribas Asset Management, Domini Impact Investments, Federated Hermes, and Christian Brothers Investment Services, among others, partnering with Ceres, the Institutional Investors Group on Climate Change and Finance for Biodiversity. This initiative will develop a target list of 100 focus companies, engage board members and executives at companies in sectors deemed important to reversing nature loss, and identify corporate actions to protect and restore nature. It parallels Climate Action 100+, an existing investor-led initiative that has driven significant investor engagement, activism and monitoring of corporate greenhouse gas emissions.

Nature Action 100's launch follows last week's Governance and Stewardship of Biodiversity Responsibilities Statement issued by the International Corporate Governance Network (ICGN), an investor-led corporate governance and stewardship coalition linked to $70 trillion in assets under management. The ICGN statement calls on investors and companies to:

- publicly commit to adopting science-based business targets (including credible interim targets) that contribute to stabilizing biodiversity loss by 2030 and to restoring ecosystems by 2050;

- give "prime consideration" to ensuring that boards of directors have access to requisite expertise and are "held to account" for progress and impacts;
- begin the process of understanding biodiversity and natural capital dependencies and impacts, using the tools deployed by leading companies;
- ensure "robust" governance procedures and board competence for overseeing how management identifies, monitors, measures and manages biodiversity dependencies, impacts, risks and the opportunities that are aligned with a company's purpose and long-term strategy; and
- align CEO and senior executive pay and incentives with a company's purpose, strategy and workforce, while respecting global best practices.

An Accelerating Investor and Stakeholder Priority

The above initiatives come at the end of a year that saw the largest institutional investors express fresh concerns about natural capital stewardship and establish material nature-related risks and opportunities as a stewardship and engagement priority. In March, State Street Global Advisors (SSgA) identified land use, biodiversity, natural resources and the circular economy as focus areas and committed to providing portfolio companies guidance on these topics and conducting targeted engagements. Then in July, SSgA issued a letter to boards noting that "global deforestation—namely its direct linkage to biodiversity loss and climate change—presents financial risk to our portfolio companies" and called on boards and management to assess deforestation and land degradation risk in their value chains and loan portfolios and to enhance public disclosures. Similarly, BlackRock in February and April discussed how its role as a fiduciary to clients has sharpened its focus on natural capital as a stewardship priority and an investment theme. Where material issues are present, BlackRock will engage with portfolio companies on nature-related topics to understand board and management roles and monitor how business models, disclosures and practices are consistent with the sustainable use and management of natural resources such as air, water, land, minerals and forests, intersect with the broader health and wealth of the world's nature-related resources and habitats, implicate biodiversity volume and variety across animal, plant and microorganism species and affect ecosystem health. T. Rowe Price also incorporates material biodiversity and nature issues in its holistic investment assessments.

Reflecting the growing awareness and pressure on these issues, shareholders brought the highest number of Rule 14a-8 shareholder proposals relating to deforestation, recycling, pesticide use and pollution in recent years, with proposals relating to sustainable packaging and eliminating deforestation and primary forest degradation in consumer goods supply chains receiving record and even majority shareholder support in several instances. Companies that defeated such proposals did so on the basis of their strong practices and disclosures. In addition, some companies have begun engaging in

structured negotiations with proponents on these issues, and other companies have embraced commitments to the long-term health of the natural ecosystems that are essential to people, biodiversity and their businesses.

With investors expressing concern that natural capital depletion and biodiversity loss have accelerated due to coinciding factors, such as land and sea use change, climate change, overuse of natural resources, and pollution, other initiatives have been launched. In August, Ceres, in partnership with a coalition of 64 investors with $9.8 trillion under management, launched the Valuing Water Finance Initiative, which seeks to engage companies with large water footprints to value and act on water as a financial risk and take action to protect water systems. Specifically, Ceres released six water protection expectations for investors to use with portfolio companies, initially requesting that large companies commit that they will, by 2030: not negatively impact water availability in water-scarce areas or water quality; not contribute to the degradation of natural ecosystems critical to freshwater supplies; actively work to restore degraded habitats; contribute to achieving universal and equitable access to water, sanitation and hygiene (WASH) across their value chain; deploy their boards and senior management to oversee water management; and ensure that all of their public policy engagement and lobbying align with sustainable water resource management outcomes.

New Focal Points for Governance, Disclosure and Reporting

New biodiversity disclosure frameworks will launch next year and, if followed, will increase public scrutiny on how companies identify and manage biodiversity risks and their impact on value chains. These frameworks all reach how the board of directors provides oversight, including through committees, and engages with management on nature-related risks and opportunities where material to the company, as well as the role of management in assessing and addressing such risks.

For example, earlier this month, the Global Reporting Initiative (GRI), the most commonly used sustainability reporting framework globally, released its exposure draft on new biodiversity standards. The GRI draft seeks new or increased disclosures on supply chain and location-specific impacts on biodiversity, management responses, the direct drivers of biodiversity loss and the impact of company operations and supply chains on ecosystems and local communities.

Just last month, the Taskforce on Nature-related Financial Disclosures (TNFD), an initiative led by senior executives, financial institutions, corporates and market service providers, including AXA, BlackRock, Bank of America, BNP Paribas and Norges Bank, representing over $20 trillion in assets under management, released an updated draft of the TNFD reporting framework, which is to be finalized in 2023. The TNFD framework will likely recommend that companies disclose their governance (across management structures and board oversight), strategy and nature-related dependencies, impacts, risks, and opportunities, including by having—and disclosing—metrics and targets. While the

TNFD draft draws upon and adapts several of the recommendations of the Task Force on Climate-related Disclosures, it also includes additional disclosures for alignment between nature and climate policies and targets, and evidence of stakeholder engagement. TNFD's first pilot program reaches 23 publicly traded member companies representing $1.3 trillion in market value and covers three systems: energy, land use (including food, agriculture and forestry) and the built environment, which are the value chains said to account for about 90% of the pressure on biodiversity. And just this week, the International Sustainability Standards Board (ISSB) announced it will incorporate natural ecosystems into its formal definition of sustainability and address their relationship to financial value creation. With biodiversity being viewed as intertwined with climate change imperatives, ISSB also announced it would consider the TNFD's work on the intersection of climate and biodiversity disclosures in scoping ISSB's own research on complementing climate-related disclosure with nature-related disclosures.

In addition, the Science Based Targets Network (SBTN), an initiative whose partners include Ceres, the World Economic Forum and CDP, is finalizing nature-related corporate guidance and targets for an early 2023 release. SBTN will provide companies with guidance on assessing, identifying, measuring, disclosing and setting targets covering nature and biodiversity impacts material to their business. SBTN seeks to mirror the Science Based Targets initiative (SBTi), but for nature and ecosystem risks.

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Biodiversity loss and adverse impacts to nature are being viewed by investors as having wide-reaching impacts on the economy and the environment, directly and indirectly touching companies across sectors, with impacts most acutely felt by enterprises with significant reliance on nature-based resources in their primary businesses or with high dependence on natural capital in their operations and supply chains. In particular, companies with global supply chains, whose weaknesses were exposed during the Covid-19 pandemic and which are being rebuilt to adapt to the evolving geopolitical landscape, may come under further pressure to reduce ecological footprints and prepare for the potential loss of, or disruption to, traditional supply sources.

Looking ahead to 2023 and beyond, companies are well-advised to understand, assess, disclose, and actively manage their material nature-related risks and opportunities and decide on the appropriate role of the board of directors. Doing so will also help companies keep up with peers, engage more effectively with investors and stakeholders on relevant nature-related business topics and respond to evolving investor pressure and expectations, even as the legal, regulatory and public policy environment evolves.

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December 15, 2022

SEC Adopts Amendments to Rule 10b5-1 and Issuer Disclosure Requirements Relating to Insider Transactions

On December 14, almost precisely a year after publication of the related proposed rules, the Securities and Exchange Commission adopted a suite of amendments to the Rule 10b5-1 affirmative defense to insider trading liability. The changes apply to both substantive requirements for the defense to be available and to disclosure-related matters. The rules will likely require issuers and insiders who use 10b5-1 plans to change the forms, policies and practices they currently employ. Notably, the new rules generally do *not* implement the previously proposed rules that would have further restricted and regulated the use of Rule 10b5-1 plans by issuers themselves (rather than corporate insiders), which the SEC notes it is continuing to consider.

A number of the new rules now make mandatory certain practices that were previously included as a prudential matter in some companies' policies and practices, but were far from universal—such as limitations on single trade plans, mandatory cooling-off periods and whether to treat significant plan modifications as equivalent to entering into a new plan. Others, such as the significant new disclosure requirements and the 90-day minimum cooling-off period for corporate insiders (which will be a significant constraint on personal financial planning), are a starker departure from existing prevailing practices.

The primary changes include the following:

Changes to requirements for Rule 10b5-1 plans: All plans designed to qualify under Rule 10b5-1 (other than plans adopted by the issuer) will be subject to a mandatory "cooling-off" period of at least 30 days following adoption of the plan before trading may begin. Directors and Section 16 officers of the issuer will be subject to an *extended* cooling-off period of at least 90 days, or until two business days following the disclosure of the issuer's financial results in a Form 10-K or Form 10-Q relating to the fiscal quarter in which the plan was adopted, whichever is longer (but not to exceed 120 days). A *new* cooling-off period will also be triggered by a modification to the amount, price or timing of a purchase or sale (including changes to related formulas or algorithms) under an existing plan, which is treated as a cancellation of the existing plan and the adoption of a replacement. The final rules also require that plans adopted by Section 16 persons include a representation from the individual certifying that they are not aware of any material non-public information about the issuer or its securities, and that they are acting in good faith and not as part of any plan or scheme to evade the prohibitions of Rule 10b-5.

Prohibition of multiple overlapping Rule 10b5-1 plans: The amendments impose a condition to the availability of the affirmative defense under Rule 10b5-1(c)(1) that the adopting person (other than the issuer) not have another outstanding qualifying plan, contract or instruction for transactions of any class of securities of the issuer on the open market during the relevant period. Limited exceptions to this prohibition apply, primarily to accommodate the fact that an individual may need to trade from multiple accounts under a single plan for logistical reasons, and to facilitate "sell-to-cover" plans designed only to provide liquidity to fund tax withholding obligations in connection with award-vesting events.

Limitation on single-trade plans: Single-trade plans (*i.e.*, plans that are designed to effect only a single transaction) may only qualify for the affirmative defense one time in any 12-month period. This limitation does not apply to issuers and is also subject to a narrow exception to permit sell-to-cover plans.

Amended good-faith condition: In addition to the existing requirement that a qualifying plan be entered into in good faith, adopting persons (including issuers) must now also "act[ ] in good faith with respect to" the plan.

Issuer Disclosure Requirements: The rules adopt a number of new affirmative disclosure requirements applicable to issuers relating to trading by insiders and equity-based compensation. Issuers will be required to disclose the adoption, termination or (in certain circumstances) modification of a Rule 10b5-1 plan or certain other pre-planned trading arrangements by any Section 16 person in their applicable periodic Exchange Act reports, including a description of the material non-price terms of the arrangements. In addition, issuers will be required to disclose in SEC filings their insider trading policies and procedures, or explain why they have not adopted such policies. Finally, significant new disclosure requirements are being imposed relating to equity compensation practices. The new disclosure must include a discussion of policies and practices around timing of grants of option-like securities, whether the existence of material nonpublic information is taken into account, and whether disclosures have been timed to impact the value of equity grants, as well as required tabular disclosure (with XBRL tagging) relating to such grants to named executive officers within a period starting four business days before (and ending one business day after) the filing of a periodic Exchange Act report or of a Form 8-K (including furnished 8-Ks) that discloses material non-public information. Triggering non-public information for purposes of this requirement includes, but is not limited to, earnings information (requiring an issuer to potentially take a public position on whether certain information constituted material non-public information).

Individual Disclosure Requirements: Section 16 filers will be required to indicate on their Forms 4 and 5 whether a reported trade was made under a Rule 10b5-1 plan, and to report "bona fide gifts" on a Form 4 within two business days (rather than being permitted to disclose on a Form 5, as under current rules).

* * * *

The new rules will become effective 60 days after publication of the adopting release in the Federal Register. Compliance with the amendments to Forms 4 and 5 will be required with respect to reports filed on or after April 1, 2023, and the new issuer disclosure requirements will apply with respect to periodic reports, information statements and proxy statements under the Exchange Act that cover the first full fiscal period that begins on or after April 1, 2023 (with delayed application to smaller reporting companies).

Given the nature and extent of the changes, the importance of the new rules for insiders seeking to manage their financial position through transactions in issuer equity, and the relatively short period prior to implementation, most issuers should promptly make their insiders aware of the pending changes and begin to implement procedures to ensure compliance. While the new rules will impose additional hurdles on the ability to rely on the Rule 10b5-1 affirmative defense, the strength of the protection offered by the defense will continue to be significant, and direct trading in open windows will also remain an available tool. Accordingly, for corporate insiders seeking liquidity, it will continue to be worth evaluating whether to implement 10b5-1 plans where circumstances permit.

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December 6, 2022

ISS and Glass Lewis Issue Final 2023 U.S. Voting Policies

Proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis have released final updates to their U.S. voting policies for the 2023 proxy season. ISS's 2023 Benchmark Policy Changes will take effect for shareholder meetings held on or after February 1, 2023, and Glass Lewis's 2023 U.S. Voting Policies will take effect for shareholder meetings held after January 1, 2023. The updates cover voting policies relating to officer indemnification and exculpation, board climate accountability and oversight, board diversity and broader board composition-related disclosures, multi-class capital structures, structural profiles of newly public companies, cybersecurity oversight, and political expenditures and lobbying congruency, among other changes. ISS also earlier announced updates to its Governance QualityScore, including the introduction of new factors that will be used by ISS in rating companies' corporate governance features, through an ISS lens.

ISS Benchmark Policy Changes. Notable updates to ISS's voting policies include:

Officer Indemnification and Exculpation. As previously discussed, Delaware has adopted amendments to the Delaware General Corporation Law (DGCL) that enable corporations to adopt exculpation provisions in their charters that would protect officers from personal liability for certain fiduciary duty claims other than breaches of the duty of loyalty, intentional misconduct or knowing violations of law, and other specified exceptions, in addition to preserving the right of the corporation to bring suits against officers and the right of stockholders to bring claims derivatively in the right of the corporation under well-established demand requirements. ISS has updated its formal voting policy on director and officer indemnification, liability protection and exculpation, and will recommend on a case-by-case basis on proposals going to a vote. ISS will generally assess whether proposed changes are reasonable, considering the stated rationale for the proposed change and the scope as well as (if applicable) whether the proposal would expand coverage beyond just legal expenses for more serious violations of fiduciary obligations than mere carelessness, and whether the proposal being voted on would provide for mandatory indemnification where indemnification was previously at the discretion of the board of directors.

ISS's final policy is less clear with respect to officer exculpation provisions than the proposed policy initially articulated by ISS in its draft benchmark policy changes (which proposed, as a default rule, that ISS generally would recommend in favor of proposals providing for exculpation to the extent permitted under state law). Notably however, ISS generally recommended in favor of officer exculpation provisions submitted for shareholder approval during the fall of 2022. It appears that ISS will be open to supporting reasonable, appropriately supported officer exculpation charter amendment proposals, subject to situation-specific concerns.

Climate Accountability. ISS has revised what it deems to be "appropriate GHG emissions reduction targets" and extended its policies with respect to board accountability for climate risk and performance globally.

ISS's revised policy on climate board accountability requires that "significant greenhouse gas (GHG) emitters"—which ISS will continue to define as companies in the Climate Action 100+ Focus Group—take minimum steps to understand and mitigate risks related to climate change to the company and the larger economy. There are two criteria used to assess whether a significant GHG emitter has taken the required minimum steps:

- *Minimum Disclosure*: A significant GHG emitter must provide detailed disclosure of climate-related risks, such as disclosures aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), including disclosure of board governance measures, corporate strategy, risk management analyses, and metrics and targets.

- *"Appropriate GHG Emissions Reduction Targets"*: ISS will define such targets to include medium-term GHG reduction targets or Net Zero-by-2050 GHG reduction targets, in each case, for at least 95% of a company's scope 1 and 2 emissions.

In cases where a "significant GHG emitter" fails to provide the aforementioned minimum disclosures and set appropriate emissions reduction targets, ISS will generally withhold from or recommend against certain responsible directors (such as the incumbent chair of the responsible committee) and/or other relevant voting items.

Political Expenditures and Lobbying Congruency. In response to the uptick of shareholder proposals requesting greater transparency on the company's alignment of its political contributions to its political commitments and/or its climate lobbying to its climate goals, ISS has adopted a new policy providing that it will generally recommend on a case-by-case basis on such shareholder proposals. Factors that ISS will consider include the company's policies, management, oversight, governance and existing level of disclosure (including payments to trade associations); any lack of congruency between its political expenditures and its stated values; and any recent significant controversies.

Board Gender Diversity. The one-year transition period for companies outside of the Russell 3000 and S&P 1500 to comply with ISS's gender diversity policy has now passed and ISS will generally withhold from or recommend against the chair of the nominating committee (or other appropriate directors) at all companies where there are no women on the board. An exception will be made if there was at least one woman on the board at the preceding annual meeting and the board makes a firm commitment to return to gender diversity within a year.

Unequal Voting Rights. The one-year grace period for companies that had been grandfathered under ISS's prior policy on unequal voting rights has expired and ISS will now withhold or recommend against directors at all companies that have unequal voting rights due to multi-class share structures. Only the following companies will be exempted from the policy: newly public companies with a sunset provision of no more than seven years from the date of going public; REIT limited partnerships and operating partnerships; situations of *de minimis* inequity (*i.e.*, where the super voting shares represent less than 5% of total voting power); and situations where the company, in ISS's view, has sufficient protections in place for minority

shareholders, such as where minority shareholders are afforded a regular binding vote on the capital structure.

Racial Equity Audit Policy. ISS has updated the policy criteria it will apply to shareholder proposals asking a company to conduct an independent racial equity audit. Starting in the 2023 proxy season, ISS will evaluate such proposals based on the following factors: the company's established framework for addressing racial inequity internally; whether the company has sufficient disclosures regarding workforce diversity and inclusion goals and metrics; whether the company has issued a public statement related to its racial justice efforts or committed to an internal review; whether the company has engaged with impacted communities, stakeholders and civil rights experts; the company's recent track record on racial justice measures and outreach; and whether the company has been the subject of recent controversy related to racial inequity.

Adverse Governance Structures of Newly Public Companies. ISS has updated its guidelines to clarify that a "newly public company" is a company that holds or held its first annual public shareholder meeting after February 1, 2015, and has established that a seven-year sunset provision will be considered a mitigating factor for problematic governance structures such as classified boards or supermajority voting.

Unilateral Bylaw/Charter Amendments. ISS has updated its Unilateral Bylaw/Charter Amendment policy to explicitly include the unilateral adoption by the board of fee-shifting provisions (*i.e.*, provisions that require a shareholder who sues a company unsuccessfully to pay litigation expenses of the defendant corporation and its directors and officers) as among the actions that, if taken, will generally result in a recommended vote against directors at subsequent shareholder meetings. ISS also explicitly adopted a catch-all for the unilateral adoption by the board of any other provision deemed "egregious."

Changes to Governance QualityScore. ISS earlier announced methodology updates to its Governance QualityScore framework, which framework is used by ISS to rate public companies against ISS's views on qualitative aspects of corporate governance. The updates include the introduction of 23 new factors across the following seven topical areas: information security; director skills; director and executive pledging; emerging risk oversight; diversity, equity and inclusion; ISS pay-for-performance concerns; and the Holding Foreign Companies Accountable Act.

Glass Lewis Proxy Voting Guidelines. Notable updates to Glass Lewis voting policies include:

Board Diversity. Glass Lewis has further expanded its expectations for board gender diversity, announced new expectations for underrepresented community diversity at the board level, and revised its policies on disclosure of director diversity and skill sets.

Gender Diversity. Starting in 2023, Glass Lewis will generally recommend against nominating committee chairs of boards at companies within the Russell 3000 index where the board is not at least 30% gender diverse. For companies outside the Russell 3000 index, Glass Lewis's existing policy requiring a minimum of one gender diverse director will remain in effect. Glass Lewis may nonetheless refrain from a negative recommendation where the board has

provided a sufficient rationale or clearly articulated a plan to address lack of gender diversity (*e.g.*, a timeline to appoint additional gender diverse directors, generally by the next annual shareholder meeting).

Underrepresented Community Diversity. Beginning in 2023, Glass Lewis will generally recommend against nominating committee chairs of boards at companies within the Russell 1000 index with fewer than one underrepresented community director, defined as an individual who self-identifies as Black, African American, North African, Middle Eastern, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaskan Native, or who self-identifies as gay, lesbian, bisexual, or transgender. As with gender diversity, Glass Lewis may refrain from recommending against where the company has provided an adequate rationale or stated a plan to remedy the lack of board diversity.

Disclosure of Director Diversity and Skill Sets. Glass Lewis assesses the quality of diversity disclosure according to four categories: (i) the board's current percentage of racial/ethnic diversity; (ii) whether the board defines diversity to explicitly include gender and/or race/ethnicity; (iii) whether the board has adopted the "Rooney Rule" requiring women and minorities to be included in the initial pool of director candidates; and (iv) board skills disclosure. Glass Lewis has revised its voting guidance to provide that it will generally recommend against the nominating committee chair and/or governance committee chair at any company in the Russell 1000 index that (1) has not provided any disclosure in **each** of the foregoing categories and/or (2) has not provided any disclosure of individual or aggregate racial/ethnic minority board demographic information.

Disclosure of Board Oversight of Environmental and Social Issues. Glass Lewis will generally recommend against governance committee chairs of companies in the Russell 1000 index that fail to explicitly disclose the board's role in overseeing environmental and social issues including, among others, matters related to climate change, human capital management, diversity, relations among stakeholders, and health, safety, and environment. The disclosure should include the company's overall governance practices as well as which directors or committees are responsible for oversight of environmental and social issues (*e.g.*, specific directors, a committee, or the entire board). Beginning in 2023, Glass Lewis will also expand its tracking of board-level oversight of environmental and social issues to all companies in the Russell 3000 index.

Board Accountability for Climate-Related Risks. Glass Lewis has heightened its expectations regarding board accountability for climate-related risks. Companies whose GHG emissions represent a "financially material risk" will be expected to provide clear and comprehensive disclosure regarding these risks in line with the disclosures recommended by the TCFD. If Glass Lewis finds a company's TCFD disclosures or its disclosures related to board oversight of climate-related issues to be lacking, it may recommend against appropriate directors.

Officer Exculpation. Glass Lewis will take a case-by-case approach to officer exculpation charter provisions and may recommend against officer exculpation provisions eliminating monetary liability for breaches of the duty of care absent a compelling rationale. We note, however, that Glass Lewis generally recommended in favor of officer exculpation charter amendment proposals that were put to a shareholder vote during the fall of 2022 that tracked

Delaware law, including the exceptions and limits to such officer exculpation set forth under the Delaware law amendments discussed above. It remains to be seen whether the phrasing of the formal voting policy will result in changes to Glass Lewis voting recommendations on such proposals.

Director Overboarding. Glass Lewis has expanded its policy on director commitments and now generally will recommend against any of the following: (i) a director who serves as an executive officer (other than executive chair) of any public company while serving on more than one external public company board, (ii) a director who serves as an executive chair of any public company while serving on more than two external public company boards, and (iii) any other director who serves on more than five public company boards.

Board Oversight of Cyber Risks. Glass Lewis has, for the first time, announced a cyber-risk oversight and disclosure policy. Glass Lewis will closely evaluate cyber-related disclosure where cyberattacks have caused significant harm to shareholders, and may recommend against appropriate directors where it finds the disclosure or oversight to be insufficient.

Long-Term Incentives. Glass Lewis has revised the threshold for the minimum percentage of the long-term incentive grant that should be performance-based from 33% to 50%, and will raise concerns with executive pay programs where less than half of an executive's long-term incentive awards are subject to performance-based vesting conditions.

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The 2023 voting policy updates announced by ISS and Glass Lewis are wide-ranging and reflect continued focus by these firms and shareholders on the oversight, management and disclosure of environmental, social and governance issues. The guidelines of ISS and Glass Lewis, although generally directionally aligned, continue to diverge in the specific requirements they impose (for example, and notably, expectations regarding board diversity), and it is prudent that boards and management carefully consider the updates in consultation with advisors to evaluate whether changes to existing practices and disclosures are warranted.

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December 2, 2022

Blockchain Technology and the Future of Digital Payments

As we recently observed, the turmoil in the cryptoasset market has been precipitated by the failures of centralized entities and bad actors, not by blockchain technology itself. Indeed, the promise of blockchain technology remains undimmed as a way to enhance payments, from international remittances to routine consumer transactions. The technology offers the attractive prospect of improving payment rails through, among other possibilities:

- providing near-instantaneous settlement (by contrast with ACH and wire transfers);
- reducing transaction costs for transferring or spending money;
- facilitating micropayments (which today are prohibitively expensive to execute);
- making money more interoperable with computer code, such as the ability to automate payments based on the satisfaction of programmed preconditions; and
- expanding financial access to the unbanked.

Making such improvements that could address deficiencies in the incumbent payment rails (through blockchain or otherwise) is all the more urgent given China's rapid progress with its digital currency, e-CNY, which has been described as a serious effort to displace the U.S. dollar's primacy as the global reserve currency.

A crucial gating item for blockchain-based payment rails, however, is determining a suitable basis for the payments. To work as an everyday currency, a digital asset must maintain a stable value — but decentralized digital assets like bitcoin have volatile prices. For the facilitation of payments, payment tokens or "stablecoins" of various designs seek to solve that problem, but the structure of each of these assets is critical. Some have proven vulnerable to extreme price volatility (or outright failure), while others, though backed by fiat money (or equivalent) reserves, may pose risks of central points of failure. Below we offer some observations on possible inroads in enhancing payment rails using blockchain technology that should be informed by, but distinguished from, the ongoing cryptoasset market crisis:

- *Money is "too big to fail."* For digital payments to gain scale, any widely utilized stablecoins should align to domestic fiat money and should not be dependent on the full faith and credit of any party other than the United States itself. Stablecoins involving fractional reserves pose run risks, and stablecoins backed by volatile cryptoasset collateral or algorithmic mechanisms are subject to devaluation risk. More viable are stablecoins issued by supervised financial institutions (subject to deposit regulations or liquidity reserve requirements) or by regulated money market funds. But even a system where stablecoins constitute the digital representation of deposits poses the familiar risks associated with a bank's failure, especially if stablecoin usage proliferates and customer deposit protection is unclear. For non-deposit stablecoins, there remain questions about how they would be considered in setting monetary policy, how competing versions of substantively identical stablecoins would be effectively employed in the marketplace, and whether the growth of such stablecoins could undermine the U.S. dollar. Accordingly,

while there may be an enduring place for stablecoins or the tokenization of bank liabilities (for notable examples of institutional use on an opt-in basis, see J.P. Morgan's JPM Coin and the Federal Reserve's pilot of a "regulated liability network"), an appropriately designed U.S. central bank digital currency (CBDC) may represent a desirable digital end-state.

- *Reform should account for the role of traditional banking*. A retail-oriented CBDC — for example, an arrangement where consumers hold fiat digital dollars in a self-hosted electronic wallet — would risk upending the traditional model of banking. While this may be viewed as desirable in some quarters, the macroeconomic effects could be significant, including by eliminating deposit funding as a source for lending. It is likely preferable (at least in its initial incarnation) for any top-down solution to begin life as a functional back-end ledger for traditional financial institutions. Such a system could eliminate significant friction from the economy and provide many of the technological efficiencies described above. And with time and thoughtful design, the possibility would remain for digital dollars to exist outside of traditional banking rails.

In the face of some reflexive political and market criticism of all things crypto-related, it bears reinforcing that despite myriad business failures with a cryptoasset nexus, blockchain technology has demonstrated that it can be effective. The use of blockchain to improve payment rails need not involve speculative mania on tokens of questionable value and remains worthy of serious further exploration to better serve important market needs and to increase the competitiveness of the United States in global payments systems.

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November 30, 2022

Thoughts for Boards: Key Issues in Corporate Governance for 2023

While the world recovers from the worst of the pandemic, the economic, political and social repercussions will continue to play out in ways that, while unpredictable, are in some respects characterized by observable patterns of cause-and-effect and cyclicality. The pendulum has been swinging back as, for example, the Federal Reserve has been ratcheting up interest rates and tightening liquidity, activist activity is once again on the rise, Republicans have taken control of the House, and back-to-office policies have been eased into effect. In this environment, stasis is the exception rather than the norm, and boards must continue to be nimble and open-minded in navigating the pitfalls and opportunities of this systemic recalibration.

Importantly, the infrastructure of corporate governance – namely, the structure and allocation of responsibilities and decision-making authority, and related principles, policies and information flows to facilitate such functioning – continues to serve as the anchoring framework for the board's oversight of dynamic business conditions. Despite the complexity and range of issues that boards today must grapple with, the basic principles of governance continue to provide the best guideposts: engaged oversight, informed decision-making, conflict-free business judgments, and balancing of competing interests to promote the overall best interests of the business and sustainable long-term growth in value.

Below are the key trends and developments that boards should bear in mind in the coming year:

- **Risk management**: Board-level systems for monitoring and controlling mission-critical functions are important to demonstrate that the board has fulfilled its *Caremark* duties, as demonstrated last year when the Delaware Court of Chancery permitted a *Caremark* duty-of-oversight claim to proceed against the directors of the Boeing Company, with the court pointing to an alleged lack of board engagement with safety issues and the absence of a committee charged with direct responsibility. However, two subsequent cases (*Hamrock* and *SolarWinds*) have reiterated the requirement that there needs to be bad faith, not just gross negligence, for a successful *Caremark* claim.

  Boards are expected to oversee significant and critical risks, and to document their oversight of the strategies, policies and procedures adopted to address those risks. In this regard, directors should seek to understand the corporation's risk profile, and its management of short-, medium- and long-term risks, as well as how risk is taken into account in the corporation's business decision-making and strategic planning. Given the challenging economic climate, boards should be mindful of possible risks relating to inflation and rising interest rates, availability and cost of financing, increases in operating costs and fluctuations in exchange rates, as applicable. We expect to see continued focus by investors and the SEC on oversight of risk management, including

with respect to how boards and committees are structured to ensure sufficient expertise to oversee key areas of risks. See our memo, Risk Management and the Board of Directors.

- **Cybersecurity**: Cybersecurity continues to be a challenging area of risk management, with plaintiffs bringing *Caremark* claims based on cybersecurity breaches, regulators requiring additional disclosures about risk management and proxy advisors factoring cybersecurity risk oversight into their governance assessments. Two Delaware decisions in the past year have addressed board oversight duties under *Caremark* with respect to cybersecurity risks. In both cases (*SolarWinds* and *Sorenson*), *Caremark* claims were asserted following a cybersecurity attack by third-party hackers who exposed the personal information of customers. Both claims were dismissed, but the court's opinions spoke to the increased risks posed by cybersecurity threats, characterizing cybersecurity as a "mission critical" risk for online providers.

  In addition, the SEC proposed rules on cybersecurity risk management in May 2022 that would require public companies to report all material cybersecurity incidents within four business days of determining the event's materiality, as well as periodic reporting about policies for managing cybersecurity risks, the board's role in overseeing cybersecurity risks and the board's cybersecurity expertise. ISS has also updated its governance "QualityScore" metrics to include information security as a factor, including third-party information security risks and related performance measures in executive compensation plans.

  Boards should ensure that they receive proper information to assist them in their oversight of cybersecurity risks, including from management experts and outside advisors, as relevant. While risks to the company's business strategy are often discussed at the full board level, it may be appropriate to consider whether oversight of cybersecurity risks should be allocated for particular focus by a board committee. See our memo, Cybersecurity Oversight and Defense – A Board and Management Imperative.

- **Cryptocurrency and blockchain**: Despite the steep decline this year in the value of cryptocurrencies and the remarkable bankruptcy of FTX, the advent of cryptocurrency assets, markets and related technologies will continue to have long-term implications not only for stakeholders like financial institutions, investment firms and payments technology providers, but also more broadly for businesses considering whether and how to leverage commercial opportunities created by cryptocurrencies, stablecoins, non-fungible tokens and blockchain technology. Major financial institutions and world governments continue to move into the crypto space, with the Federal Reserve Bank of New York testing digital dollar tokens with major banks and China's introduction of e-CNY, its central bank digital currency. In addition, the E.U.'s Markets in Crypto-Assets regulations are expected to come into

effect in 2024, and proposed legislation in the U.K. would give the Financial Conduct Authority powers to regulate cryptoassets.

When considering cryptocurrencies or uses of blockchain technology, directors must not only be mindful of the risks and opportunities presented by the current state of play (including cybersecurity concerns, accounting and tax implications and other operational risks), but also consider the rapidly evolving nature of the crypto ecosystem. Even corporations that at first glance seem unlikely to be affected by crypto developments may find themselves exposed to peripheral risks, whether through relationships with institutions that are players in the crypto space or supplier networks that utilize blockchain. As a result, it will be important for boards and management teams to work collaboratively to understand developments in this area. As relevant, boards should consider creating committees to deal with questions of digital assets and demonstrate strong internal controls over digital assets. See our memo, Cryptoassets and the SEC's Mandate.

- **Politicization of ESG, and questions about the "woke" corporation**: We have previously remarked on the widespread acceptance of stakeholder governance and, relatedly, the value of considering ESG factors in corporate decision-making. The last year has seen a new movement of anti-ESG backlash that is opposed to consideration of ESG factors, in a push to revert to the outdated notion that the purpose of a corporation is to increase short-term shareholder profits. However, this politicization of ESG does not alter the board's ability to consider ESG factors; to the contrary, such consideration is consistent with the board's fiduciary duty of care, as well as the board's *Caremark* obligations to identify and address material risks.

  Properly understood, ESG is not a unitary principle but rather encapsulates a wide range of risks and opportunities that a corporation must balance, taking into account its specific circumstances, in seeking to achieve long-term, sustainable value. A holistic view of corporate purpose recognizes that various stakeholder interests and relationships – including those relating to environmental sustainability, the safety and well-being of employees, co-dependencies with local communities in key locations, credibility with regulators, and creditworthiness with lenders and suppliers – are among the considerations essential to maintaining a thriving, growing business. See our memo, Understanding the Role of ESG and Stakeholder Governance within the Framework of Fiduciary Duties.

- **Climate disclosure**: In the coming year, the SEC is set to release or adopt several new ESG disclosure rules, including the final climate disclosure rules, following their initial proposal in draft form in March of 2022. These rules are expected to leverage the growing standardization of climate-related disclosures and, if adopted, they would require disclosures about board and management oversight and governance of material climate impacts, greenhouse gas emissions, as well as targets and transition plans. The International Sustainability Standards Board continues its drive toward a global baseline of sustainability disclosures, including a requirement for disclosure of

Scope 3 emissions, subject to certain safe harbors that will be unveiled in forthcoming standards to be finalized next year. Simultaneously, there has been enhanced scrutiny of "greenwashing" over the last year, with private lawsuits alleging deceptive marketing, skepticism about sustainability-linked financing and additional SEC enforcement actions alleging misleading climate-related disclosures. While the regulatory landscape continues to evolve, companies are well-advised to work toward compliance with the Taskforce on Climate-related Financial Disclosures and the Sustainability Accounting Standards Board disclosure frameworks, as these are the core of the private market-led disclosure guidelines which have received widespread buy-in from corporations and have been endorsed by major institutional investors.

- **Activism preparedness and defense; universal proxy cards**: The volume of activist activity has rebounded from the relatively muted level of engagement during the height of the pandemic, with a 20% year-over-year increase in activist activity during the first half of 2022. The volatility and general decline in equity values has created vulnerabilities for many companies, as well as opportunities for activists, and this dynamic will continue to play out in the coming year. In addition, activists continue to leverage ESG topics as wedge issues to rally the support of institutional investors around economic and governance theses (*e.g.*, Engine No. 1/Exxon, Carl Icahn/McDonalds and Third Point/Royal Dutch Shell).

  At the same time, the new SEC rule requiring a universal proxy card in director election proxy fights became effective earlier this year. The universal proxy card will facilitate proxy contests by reducing the cost and effort required for activists to nominate and solicit proxies for the election of board members. It could also lead to a greater focus in proxy fights on the track records and skill sets of individual directors, rather than the performance of the company or board as a whole, because a universal proxy card will enable shareholders to pick and choose individual directors from the company's and the activist's competing slates.

  In preparing for the use of universal proxy cards, some companies have been updating their bylaws to reflect technical updates, and, in a few cases, they have enacted more aggressive bylaw amendments that have been met with resistance. For example, there is a pending lawsuit against Masimo Corporation in Delaware over its bylaw amendment requiring nominating shareholders to disclose information about their own investors, other investors with whom they have spoken, as well as other companies for which they are also nominating directors.

  Another development that may impact voting dynamics is the initiative by some large asset managers to provide their retail clients with the ability to directly participate in voting decisions: BlackRock implemented this technology for certain assets a year ago, Vanguard is reported to be considering a trial of similar technology, and State Street announced in November that they are considering the possibility of providing investor choice in more of its products.

- **D&O exculpation and insurance**: Earlier this year, Delaware adopted an amendment to its corporation laws to permit exculpation of officers (in addition to directors) from personal liability for monetary damages in corporate charters. Such an exculpation provision is not self-effectuating. Implementation requires an amendment to the corporation's certificate of incorporation which, in turn, requires approval by the corporation's shareholders. According to its recently released policies for 2023, ISS will generally vote for proposals providing for exculpation provisions in a company's charter to the extent permitted under applicable state law.

  Officer exculpation may help to eliminate the unequal and unfair targeting of officers for negligence claims in stockholder litigation, while at the same time preserving avenues for officers to be held accountable. Notably, the scope of permissible indemnification is limited, insofar as it only allows exculpation for direct claims brought by stockholders and does not eliminate officers' monetary liability for breaches of their duty of care pursuant to claims brought by the corporation, or for derivative claims made by stockholders on behalf of the corporation. In addition, the amendment would not limit the liability of officers for breaches of the duty of loyalty, any acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law, and any transaction from which the officer derived an improper personal benefit. See our memo, Delaware Approves Permitting Exculpation of Officers from Personal Liability in Corporate Charters.

- **Clayton Act Section 8**: The Department of Justice recently announced that it is ramping up efforts to enforce Section 8 of the Clayton Act, which prohibits officers and directors from serving with competing companies simultaneously. There are certain de minimis safe harbors for interlocked companies whose competing sales are less than $4.1 million (as of 2022) or where the competing sales make up only a minimal percentage of total sales, as well as a one-year grace period to resolve a violation created by changed circumstances. Several companies have already received civil investigative demands, with a particular focus on private equity sponsors (*e.g.*, Thoma Bravo and its investments in Dynatrace and Solarwinds) based on a theory of corporate deputization that focuses on firms rather than specific individual interlocks at portfolio company boards. The DOJ appears to have established an internal task force dedicated to enforcing Section 8, and we expect additional enforcement actions and press releases to come. Companies should accordingly review their board memberships for competitor interlocks. See our memo, Antitrust Division Actively Seeking to Break up Corporate Interlocks.

- **Executive compensation clawback rules**: Pursuant to the SEC's final compensation clawback rules under the Dodd-Frank Act, which were released earlier this year, publicly traded companies must adopt policies allowing them to "claw back" incentive-based executive compensation awarded on the basis of materially misreported financials that subsequently require an accounting restatement. The clawback mechanism applies regardless of whether the restatement was caused by

error, fraud or otherwise, and greatly expands the SEC's authority to force companies to claw back executive compensation following a restatement. The new rules allow for limited board discretion in whether to seek recovery from officers, and boards are prohibited from indemnifying officers for recovered compensation. While many public companies already have clawback policies in place, they should assess whether they meet the SEC's new requirements on the anticipated schedule. See our memo, SEC Adopts Final Compensation Clawback Rules.

- **Board Diversity**: Board diversity continues to be an area of focus by major institutional investors, proxy advisors and regulators, and in recent years the composition of boards has evolved accordingly, with 72% of the incoming S&P 500 class of directors appointed in 2022 coming from historically underrepresented groups. According to a recent survey, half of all S&P 500 boards have a policy like the "Rooney rule" to include candidates from underrepresented groups in the candidate pool when recruiting new directors. Beginning in 2023, Glass Lewis will recommend against the chair of the nominating committee of a board that is not at least 30% gender diverse, absent credible disclosure of a commitment to increase board diversity in the new future. Institutional investors, like State Street, have made similar commitments on gender diversity, and are also calling for disclosure of the racial and ethnic composition of boards. Looking forward, new proposed SEC rules on the disclosure of board diversity are expected in April 2023.

In addition to these key trends and developments, directors and companies should remain mindful of other recommended practices in corporate governance:

Boards should:

- Maintain a working partnership with the CEO and management and serve as a resource for management in charting the appropriate course for the corporation;
- Set the "tone at the top" to create a corporate culture that not only gives priority to ethical standards, professionalism, integrity and compliance in setting and implementing both operating and strategic goals, but that also is a reflection of, and a foundation for, the corporation's purpose;
- Choose the CEO, monitor the CEO's and management's performance and develop and keep current a succession plan that takes into account potential candidates as well as the objectives and challenges that the corporation faces;
- Oversee corporate strategy (including purpose, culture and vision) and the communication of that strategy to investors, recognizing that investors want to be assured about not just current risks and problems, but also threats to long-term strategy from global, political, climate, social, economic and technological developments;
- Determine the appropriate level of executive compensation and incentive structures with the basic objective of recruiting and retaining the best management available,

and with awareness of the potential impact of compensation structures on business priorities and risk-taking, taking into account specific goals like climate sustainability and current stakeholder, proxy advisor and public and political views on compensation;

- Be prepared to take an active role in matters where the CEO may have a real or perceived conflict, including in the context of takeovers and attacks by activist hedge funds focused on the CEO;
- Receive updates from management or advisors, as appropriate, on changes to regulatory guidance, disclosure requirements and other changes in law which may affect the management of the corporation;
- Have a lead independent director or a non-executive chair of the board with clearly defined duties and responsibilities who can facilitate the functioning of the board, serve as a liaison between the independent directors and management, and assist management in engaging with investors, other stakeholders, their advisors such as S&P and ISS and with regulators;
- Together with the lead independent director or the non-executive chair, determine the agendas for board and committee meetings and work with management to ensure that appropriate information and sufficient time are available for full consideration of all matters;
- Recognize that shareholder engagement is a central component of corporate governance, and participate, as appropriate, in proactive outreach efforts to communicate with and listen to shareholders and other stakeholders;
- Work with management to anticipate possible takeover attempts and activist attacks, understand activist and acquiror tactics, and keep response playbooks up-to-date in order to be able to address these attempts or attacks more effectively, if they should occur; in this regard, it may be prudent to meet at least annually with the team of the corporation's executives and outside advisors that will advise the corporation in the event of a takeover proposal or an activist attack;
- Evaluate the performance of individual directors, the board and board committees on a regular basis and consider the optimal board and committee composition and structure, including board refreshment, expertise and skill sets (including as it pertains to climate, diversity and key risk areas), independence and diversity, including with a mind to the evolving Delaware jurisprudence on what constitutes "independence" for directors;
- Consider whether to create additional committees focused on key risk areas, such as cybersecurity or cryptocurrency, in order to demonstrate appropriate risk management;
- Review corporate governance guidelines, committee charters and workloads and tailor them to promote effective board and committee functioning; and

- Determine that appropriate records of the foregoing are timely created and maintained.

Corporations should seek to:

- Have a sufficient number of directors to staff the board's committees and to meet investor and other stakeholder expectations regarding experience, expertise, diversity and periodic refreshment;
- Have directors who have knowledge of, and experience with, the corporation's businesses and the key developments and drivers that impact those businesses, even if this results in the board having more than one director who is not "independent";
- Have directors who are able to devote sufficient time to preparing for and attending board and committee meetings and engaging with investors and other stakeholders;
- Recognize that institutional investors and other third-party ESG activists will monitor the composition of the board of directors for expertise on particular aspects of ESG (including climate change and diversity) and for presence on the board of known opponents of an ESG issue;
- Provide directors with all the data that is necessary for making sound decisions regarding performance, strategy, compensation, risk management, climate change, diversity, other ESG issues, financial stability and stakeholder allocation;
- Provide directors with relevant reporting on material decisions or industry trends, such as the use of artificial intelligence and cryptocurrency, as well as corporate cybersecurity defense and readiness;
- Provide directors with regular tutorials by internal and external experts as part of expanded director education, and provide directors with the information and expertise they need to respond to disruption, evaluate current strategy, strategize beyond the horizon and integrate and balance the interests of stakeholders; and
- Maintain a collegial relationship among and between the corporation's senior executives and members of the board that facilitates frank and vigorous discussion and enhances the board's role as strategic partner, evaluator and monitor.

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November 28, 2022

Understanding the Role of ESG and Stakeholder Governance
Within the Framework of Fiduciary Duties

Over the past decade, investors, companies, and commentators have increasingly accepted and adopted stakeholder governance as the way to pursue the proper purpose of the corporation and have embraced consideration of environmental, social and governance (ESG) issues in corporate decision-making toward that end. But an emerging movement opposed to any consideration, at all, of ESG factors threatens to erase the gains that have been made over the past ten years and revert to the outdated view that the purpose of a company is solely to maximize short-term shareholder profits.

This debate is playing out very publicly, with politicians at the highest levels of state and federal government publicly staking out positions on ESG and the extent to which it should (or should not) be considered by asset managers; through regulation and law; and in boardrooms across the country and around the world. At one extreme, critics of ESG are dismissing any consideration of the long-term impact of environmental or social risk on a company as "woke" capitalism, to be condemned, if not outlawed. (See Bloomberg, Populist House Republicans Picking a Fight With US Business Over 'Woke Capitalism' (Nov. 27, 2022).) At the same time, attacks from the other end of the spectrum condemn board consideration of ESG in a stakeholder governance model as insufficiently prescriptive. Yet neither view, attempting to politicize the role of companies and their boards, grapples adequately with the real meaning of ESG and stakeholder governance and the role of these concepts in the decision-making process of corporate boards and management.

ESG, properly understood, is not a monolithic concept, but rather refers to the panoply of risks and policies that a company must carefully balance in seeking to achieve long-term, sustainable value. To be sure, political action may be necessary to meaningfully confront climate change and other environmental and social challenges to the long-term success of the U.S. economy and global prosperity. But separate and apart from that political will — and all the debate that should properly surround it — it remains incumbent upon and entirely within the purview of each board of directors to look beyond short-term shareholder profits and seek sustainable long-term value creation, taking into account all stakeholders, including those implicated by ESG matters. With this in mind, we write to correct recent misinformation about stakeholder governance and ESG, and to explain how the consideration of ESG, properly understood, as well as other stakeholder factors, is entirely consistent with the fiduciary duties owed by the board and management to the company and to shareholders, and indeed required if board and management are to act prudently.

Defining Stakeholder Governance and ESG

The long-running debate over whether the purpose of the corporation is to maximize short-term profits for shareholders or, alternatively, to operate in the interest of all stakeholders to promote long-term value, dates back to the 1932 law review exchange between Merrick Dodd (here) and Adolf Berle (here). Milton Friedman's 1970 essay, The Social Responsibility Of

Business Is to Increase Its Profits, epitomizes the former view, known as shareholder primacy, which posits that the sole role of the corporation is to maximize shareholder profits. In Friedman's words, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits."

We have long advocated for a broader view of corporate purpose than Friedman's and the shareholder primacy theory: first, as described in 1979 in Takeover Bids in the Target's Boardroom, to empower boards to consider the interests of all stakeholders, including the communities in which corporations operate, in repudiating takeover bids by opportunistic raiders; and later, to encourage directors to resist short-term pressures and allow boards to exercise their business judgment to evaluate the variety of stakeholder interests that are essential to promoting sustainable success and growth in long-term corporate value.

Shareholder primacy dominated the thinking of corporate leaders, lawyers, academics, investors, and asset managers for the latter half of the twentieth century. The error and the dangers of strict adherence to this theory were plainly exposed by the 2008 financial crisis. The severity of the global economic recession laid bare the reality that exclusively focusing on short-term maximization of shareholder value comes at the cost of sustainable growth and innovation, and marked the beginning of the decline of the doctrine. In the years following the financial crisis, business leaders, policymakers, and investors increasingly advocated for a more expansive conception of corporate purpose, one that promotes growth in long-term corporate value.

The rejection of shareholder primacy and embrace of stakeholder governance is illustrated by, among other actions, the World Economic Forum's publication of The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth in 2016, the development of the British Academy's Future of the Corporation project beginning in 2018, and the issuance of the Davos Manifesto 2020.

On the corporate front, the Business Roundtable, whose membership consists of the chief executive officers of most of the major U.S. companies, in 2019 rejected the shareholder-centric view to which it had held firm over the prior two decades, instead recognizing that "[e]ach of our stakeholders is essential" and committing "to deliver value to all of them, for the future success of our companies, our communities and our country."

The major index fund managers, which collectively own a meaningful percentage of the shares of all U.S. public companies, have likewise embraced stakeholder governance. Larry Fink, CEO of BlackRock, stated in his January 2022 letter to CEOs (and expressed similar views in previous annual CEO letters dating to 2018) that "[i]n today's globally interconnected world, a company must create value for and be valued by its full range of stakeholders in order to deliver long-term value for its shareholders. It is through effective stakeholder capitalism that capital is efficiently allocated, companies achieve durable profitability, and value is created and sustained over the long-term." State Street, in its January 2022 letter to board members, similarly framed its comments starting from the premise that "strong, capable, independent boards exercising effective oversight are the linchpin to creat[ing] long-term shareholder value." Likewise, Vanguard in its 2021 Investment Stewardship Annual Report stated that they "are tireless

advocates for the highest standards of corporate governance worldwide and the sustainable, long-term value of . . . shareholders' investments."

These developments illustrate how financial market participants — companies, boards, index funds, practitioners, and academics, among others — are moving beyond the short-term, shareholder-centric view that had dominated corporate law and policy since the 1970s and are embracing long-term, sustainable value creation as the proper objective of for-profit corporations. Widespread support for and adoption of this model is imperative to enable companies to drive socioeconomic prosperity not just today, but in the future.

Consistent with the increasing prominence of stakeholder governance, much attention has been paid to ESG principles in recent years. The term ESG was popularized in the early 2000s following the publication of the UN Global Compact's report Who Cares Wins, and is an acronym that refers to three categories of risks, practices, and policies — "environment," "social," and "governance" — that companies should consider. For example, the "environment" component of ESG could involve actions designed to reduce greenhouse gases, to recycle plastics or to treat waste to avoid polluting rivers; the "social" component could involve the health, safety, diversity or wages of employees, or it could involve the corporation's relationship to the communities and governments which the corporation impacts; and the "governance" component concerns the relationship between and among the corporation's shareholders, directors, and management. As we previously wrote in Risk Management and the Board of Directors, and as we explore in this memo, each of the policies, practices and actions embraced within the ESG components and sub-components represent risk that must be managed by the corporation, its management, and its board of directors, and the failure to oversee and address such risks may subject directors to potential liability, and the corporations that they oversee to grave danger of failure and destruction of shareholder value.

The increasing concern about the matters encompassed in ESG in the United States has coincided with greater focus on human capital issues and the treatment of employees in the workplace (in part arising out of the Covid-19 pandemic), widespread commitments to addressing systemic racism and injustice, emphasis on diversifying membership on corporate boards of directors (across numerous types of diversity, including gender and ethnic diversity as well as diversity of background and experience), and growing momentum to combat environmental degradation and climate change. The rise of concern about ESG matters in the United States mirrors the growth of similar movements in other countries around the world, which likewise are debating the complex questions about corporate purpose, social responsibility, long-term sustainability, and value creation that lie at the heart of stakeholder and ESG governance.

ESG, properly understood, is not a single principle or an assemblage of a fixed set of principles. To the contrary, ESG refers to a range of policies, practices, and risks that a company must carefully balance, taking into account its specific circumstances, in seeking to achieve long-term, sustainable growth in value. Consider climate change as one example: climate change poses significant risks to many companies, insofar as it has resulted in (and will continue to result in) physical impacts such as a rise in sea levels, more frequent and intense weather, and more severe wildfires, and likely will be the subject of future regulation and governmental

policy. Embracing ESG does not mean that a company will make decisions exclusively with the goal of preventing climate change — it simply means that a company will consider whether and how to minimize the effect of these impacts and weigh potential future actions that could impact climate change against the corresponding risk and against other material considerations to arrive at the optimal outcome for the company. This is not only the socially responsible course of action, but also the one that best promotes long-term sustainability and value creation for the benefit of the shareholders and other stakeholders.

Each element of ESG stands alone and represents a different set of important issues that companies must carefully balance in order to ensure their viability and success over the long term. Although critics lump the three pillars of ESG into one category in service of their argument that ESG is simply a pretense to favor companies with liberal values, this misunderstands how companies can and must utilize ESG in practice, and entirely ignores the reality that management and boards have long considered ESG risks and factors in making decisions, whether or not explicitly doing so under the rubric of ESG.

Indeed, ESG considerations long have factored into corporate and investment decision-making in a number of ways: Companies and boards consider stakeholder and ESG issues when creating products and services; making business decisions; assessing and managing risk; developing long-term strategy; recruiting and retaining talent and investing in the workforce; implementing compliance programs; and crafting public disclosures. Pressure on ESG issues is commonly exerted on companies through the submission of shareholder proposals on ESG topics (which the SEC has made significantly easier), campaigns to vote against directors at annual meetings, messaging by large institutional investors in engagement meetings with company management, and as a key issue or critique advanced by activist shareholders. Major asset managers take ESG considerations into account when formulating investment strategies, exercising fiduciary responsibilities, and promoting the reduction of risk in their clients' investments, and they expect well-run companies to do the same. Certain ESG investment funds invest exclusively in companies that satisfy predetermined ESG standards. Regulators and enforcement authorities develop principles to promote consistency and reliability across ESG disclosures, scrutinize such disclosures in companies' public filings, and compel noncompliant companies to improve inadequate disclosures. The commitment to ESG by the public sector, the private sector, and regulators is for good reason — consideration of ESG factors and risks is associated with superior financial results and is critical to ensuring that the company is sustainable over the long term.

However, not all market participants embrace ESG principles. Recently, an anti-ESG movement opposed to consideration of ESG factors in corporate and investment decision-making has emerged and, unfortunately, caused great confusion about what ESG is, how it factors into decision-making, and the extent to which directors are legally permitted, or required, to consider such factors. This fast-growing movement has politicized ESG, detracted from what ESG, properly understood, means, and put companies, boards, and asset managers in the crosshairs of politicians using ESG as a divisive issue.

One cogent example of the politicization and polarization of ESG is the letter sent to BlackRock this past August by 19 Republican state attorneys general accusing BlackRock of

prioritizing its "climate agenda" over the interests of pensioners' investments. BlackRock replied clarifying inaccuracies and reaffirming that its participation in ESG climate initiatives is entirely consistent with its fiduciary obligations. More recently, five Republican senators sent a letter to 51 law firms advising them to "preserve relevant documents" in anticipation of investigations into "institutionalized antitrust violations being committed in the name of ESG." In response to the Republican senators' letter, 17 Democratic state attorneys general wrote to the chairs and ranking members of the Senate Banking, Housing, and Urban Affairs Committee and the House Financial Services Committee arguing that public pension fund managers may, consistent with their fiduciary duties to maximize returns for beneficiaries, consider ESG factors, and refuting the claim in the Republican senators' letter that doing so may implicate liability under antitrust and competition laws.

The politicization of ESG has gone beyond political sparring — certain states with conservative leadership have taken concrete action in the form of divestment, legislation, and/or civil investigations to deter or prevent companies and fund managers from considering ESG issues. For example, Louisiana announced that it had withdrawn $560 million from BlackRock's funds in protest of BlackRock's anti-fossil fuel policies. Louisiana is not alone in deciding to divest from BlackRock in connection with the politicization of ESG matters — similar announcements have been made by states including Missouri (which announced in October that it pulled $500 million out of funds managed by BlackRock), South Carolina (which announced in October it would be divesting $200 million), Arkansas (which announced in March that it had divested $125 million), Utah (which announced in September it had divested $100 million), and West Virginia (which announced in January it was completely divesting from BlackRock). Although the divestments (both individually and in the aggregate) are a rounding error to the amount of funds managed by BlackRock, the symbolic impact is significant — the divestments have helped propel the anti-ESG movement and served as a call to arms for opponents of so-called "woke" capitalism.

Further, Texas enacted legislation requiring state pension funds and school funds to divest from financial institutions that the state determines "boycott energy companies," which list included BlackRock. The Florida State Board of Administration likewise passed a resolution specifying that investment decisions "must be based only on pecuniary factors [which] do not include the consideration of the furtherance of social, political, or ideological interests" (and which resolution was accompanied by a statement by Governor DeSantis emphatically stating that ESG considerations "will not be included in the state of Florida's pension investment management practices"). Finally, in October, a coalition of 19 state attorneys general announced an investigation into six major banks (Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo) regarding their involvement with the United Nations' Net-Zero Banking Alliance, in which member banks have committed to set emissions-reduction targets in their lending and investment portfolios to reach net zero by the year 2050.

These examples underscore precisely how politicized ESG has become in recent months, with actors on both sides of the political spectrum using ESG in aid of attacks on the other party, on companies, on banks, and on fund managers. But ESG, properly understood, is inherently apolitical — it merely refers to various types of policies, practices, and risks that are material to long-term sustainability and value-creation, and that must be considered and balanced (along

with and against all other factors and policies, practices, and risks that are material) by companies and boards. ESG has, unfortunately, and wrongly, become a political lightning rod. But once ESG is properly defined and contextualized, it is abundantly clear that consideration of ESG principles is not only sensible business strategy, but also is necessary to ensure long-term sustainability and value-creation, and to fulfill the fiduciary duties owed by the board and management to the corporation and to shareholders.

Stakeholder Corporate Governance, ESG, and Fiduciary Duties

As we have previously explained here and here, the purpose of a corporation can be summarized simply, as follows:

> The purpose of a corporation is to conduct a lawful, ethical, profitable and sustainable business in order to ensure its success and grow its value over the long term. This requires consideration of all the stakeholders that are critical to its success (shareholders, employees, customers, suppliers and communities), as determined by the corporation and its board of directors using their business judgment and with regular engagement with shareholders, who are essential partners in supporting the corporation's pursuit of its purpose. Fulfilling this purpose in such manner is fully consistent with the fiduciary duties of the board of directors and the stewardship obligations of shareholders.

The objective of creating sustainable, long-term value recognizes that the purpose of for-profit corporations includes value creation for investors, but also recognizes that the interests of other constituents — namely employees, customers, suppliers, and communities — are inextricably linked to that very creation of long-term value. Vindicating this concept of corporate purpose necessarily requires consideration of ESG principles — failure to do so would undermine the long-term value and success of the enterprise.

In carrying out decision-making, corporate law imposes on boards a fiduciary duty of care to act on a reasonably informed basis after due consideration of relevant information and appropriate deliberation. This means that directors must take actions necessary to assure themselves that they have the information required to take, or refrain from taking, action; that they devote sufficient time to the consideration of such information; and that they obtain, where helpful, advice from appropriate experts. As we set out here, there should be no doubt: Long-term value maximization as the corporation's purpose and objective is entirely consistent with the board's fiduciary duty.

By ignoring or not taking into account the interests of stakeholders and ESG considerations, a corporation will not be able to sustain itself over the long term. Considering the interests of not only shareholders, but also all who are critical to the success of the company, is essential to ensuring long-term sustainability, and is consistent with the board's fiduciary obligation to inform itself of and consider ***all*** relevant information. To be sure, Delaware courts have long recognized and accepted that, outside of the context of a change-of-control transaction,

corporate boards can and should take into account the interests of all relevant stakeholders in pursuing long-term value for the corporation. Doing so is consistent with the fiduciary duty of care, as well as with the board's obligation under the *Caremark* doctrine to implement and monitor systems to identify material risks, and to address risks once identified. It is imperative that companies oversee and address ESG and sustainability-related risks as such risks can damage and disrupt a corporation's strategies, business positioning, operations, and relations with stakeholders. Whether or not directors should face *Caremark* liability for failure to monitor ESG-related risks as a doctrinal matter, it is clear that directors may consider such issues in connection with their duty of care and, indeed, must do so to preserve and protect the long-term value of the company.

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In recent months, the concept of ESG has become fraught with political and legal implications as actors and lawmakers on both sides of the political spectrum and at all levels of government have seized on ESG and attempted to conflate it with progressive or liberal values. Asset managers are commonly the target of anti-ESG attacks, as are companies, boards and executives. These attacks and attempts to besmirch the ESG rubric misunderstand that the concept of ESG is as simple as it is uncontroversial: ESG is merely a collection of the risks and issues that all companies must carefully consider and balance, taking into account their own specific circumstances, in seeking to achieve sustainable, long-term value. The politicization of ESG does not alter or undermine the ability of boards and companies to consider stakeholder and ESG risks and issues.

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November 15, 2022

Initial Observations on the FTX Debacle

The dust has not yet settled from the remarkable fall to earth of cryptoasset exchange FTX, associated hedge fund Alameda, and their Icarus-like founder, as revelations and conjecture continue to be disseminated at least daily about what happened and the collateral damage. While there are sure to be many important lessons from this situation as the facts and their effects become clear, some initial observations bear mentioning:

- *Key recent failures were of centralized parties, not of blockchain technology itself.* It is ironic that the cryptoasset market, predicated on the concept of decentralization, has been brought low of late by the failure of FTX and other centralized parties, including cryptoasset lenders Celsius and Voyager as well as hedge fund Three Arrows Capital. While decentralized blockchain protocols are by no means immune from design flaws (as witnessed with the failure of the so-called stablecoin UST), and while smart contract computer code is not immune to error and hacking, the core technology of blockchain remains functional and the push to organize all blockchain technology into legacy centralized forums is proving ineffective. This is not to say that centralized blockchains are inherently problematic — many companies are employing private, "permissioned" blockchains to good avail in areas such as supply chain management, and even the Federal Reserve is piloting blockchain payments. In short, recent failures of some technology-related institutions should not prompt rejection of the technology itself. To the contrary, these failures remind us of the initial inspiration for its creation and reinforce the need for thoughtful and calibrated regulation, which may differ from the regulatory tools used in the past.

- *Well-tailored regulation can help to mitigate fraud risk.* As we wrote over a year ago, "protective features of the traditional financial system did not spring forth fully formed with the advent of markets, but evolved as a result of bitter experience which need not be relearned now at the expense of crypto investors." Based on what is currently known about FTX's collapse, the cryptoasset market is reminded of some painful lessons of the past, be it Madoff, Enron, or otherwise. While too many questions remain about FTX to conclude what measures might have arrested its meteoric rise and fall, we do believe that certain baseline measures warrant immediate consideration for similar entities. For instance, centralized parties (*e.g.*, centralized exchanges) receiving customer assets should be subject to robust internal controls under the purview of external auditors — of the sort mandated by Sarbanes-Oxley Sections 302 and 404 — and a specific requirement that a custodian of customer assets be duly qualified by, and subject to, state or federal regulation. Furthermore, as we have previously remarked, legislative delegation of clear regulatory authority for spot cryptoasset exchanges is essential. Measures such as these should be welcomed by the industry.

- *U.S. market leadership is paramount; regulatory arbitrage is perilous.* While FTX's U.S. arm has been swept into its bankruptcy, the preponderance of FTX's business was

established and operated offshore, as is the case for many companies in the cryptoasset industry. This is in no small measure attributable to continuing uncertainty with respect to U.S. regulatory treatment of cryptoassets and decentralized financial protocols, as well as regulators' continued prioritization of enforcement tools as opposed to tailoring of "traditional finance"-focused rules for cryptoassets' idiosyncratic features. Clear and more readily navigable domestic U.S. rules of the road would help both to maintain U.S. leadership in this new economic sector and to avoid regulatory arbitrage posing risk of inadequate oversight. And while the fallout from FTX's failure is sure to provide momentum for increased regulation — which is, in our view, entirely appropriate — at the same time it is important to avoid draconian responses that could tend to further drive the industry (and U.S. customers) to less safe shores.

Already polarized views on crypto are likely to be exacerbated by FTX's implosion, reinforcing both the general skepticism of crypto critics and the fervor of blockchain true-believers about the need to disintermediate financial systems by trusting in cryptography rather than centralized institutions. But these views should converge behind the goal of establishing robust systems where consumer assets are protected against third-party misuse. This objective would be well-served by balanced regulation that accounts for the novel realities of crypto and the distinctive nature of decentralized finance, as well as the unfortunately familiar realities of scandalous business conduct.

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November 10, 2022

Preparing for the 2023 Proxy Season in the Era of Universal Proxy

The universal proxy card, which came into effect on September 1, 2022, represents an important development in shareholder voting: for the first time, all shareholders will be able to vote for their preferred mix of board and dissident director nominees at a contested meeting. While the framework by which major institutional shareholders and the influential proxy advisers ISS and Glass Lewis evaluate proxy contests remains unchanged—dissidents will still need to make a compelling case for change and propose proportionate solutions and qualified nominees—the universal proxy card may meaningfully change the dynamics of contested elections. One consequence is clear: individual director candidates will face increased scrutiny by shareholders and proxy advisors. Shareholders will be able to engage in "elective surgery" and opt away from individual board-nominated candidates whose skills, backgrounds, experiences and contributions compare unfavorably in their view relative to those of individual dissident nominees. With shareholders—and the proxy advisory firms—now able to "cherry pick" from among the entire set of board candidates in a contested election, both the board and dissidents will be expected to more clearly communicate and demonstrate the strengths of each individual nominee.

The universal proxy card rules also come at a key juncture in the economic cycle. Macroeconomic headwinds, trading multiple compression and a bearish earnings outlook have all aided the resurgence of shareholder activism. Investor focus on ESG issues also remains strong. The past proxy season saw a record number of shareholder proposals and continued uptick in private engagement. It is possible that some proponents (including smaller social activists that have previously submitted Rule 14a-8 proposals) may seek to leverage the lower cost of entry created by the new universal proxy card rules to nominate directors as part of ESG-oriented campaigns.

The new universal proxy rules will require a review of company bylaws to ensure that appropriate amendments are implemented to provide sufficient notice and time to prepare for a contested election. Companies would also be well advised to review their preparatory practices prior to their next annual meeting, including board and management readiness, shareholder engagement and outreach, proxy statement and related public disclosures, and board refreshment and composition strategies. We summarize our recommendations below.

Summary of Key Rule Changes

The universal proxy rules require the use of proxy cards listing the names of all director candidates in a contested election, regardless of whether the candidates were nominated by the board or shareholders. Shareholders will be able to "mix and match" their votes for dissidents and board nominees. The new rules also set forth minimum solicitation and notice requirements, including the requirement that dissidents solicit holders of a minimum of 67% of the voting power of shares entitled to vote in the election. Unlike proxy access, the universal proxy rules do not impose minimum ownership thresholds or holding periods nor do they cap the number of nominees. Each side will need to conduct its own solicitation and may use notice and access to deliver its proxy materials and comply with the requisite solicitation requirements. In addition, the "short slate" rule has been eliminated, and the "bona fide nominee" rule has been amended to include nominees that consent to being named in any proxy statement for the applicable shareholder meeting.

Notably, the Securities and Exchange Commission ("SEC") has not mandated identical universal proxy cards. The new rules require proxy cards to list all nominees, to distinguish among board, dissident and proxy access nominees, to use the same font type, style and size to present all nominees, and to disclose the maximum number of nominees for which voting authority can be given, but the board and dissidents have free reign to make tactical decisions on how to group nominees, including whether to identify nominees recommended or opposed by their side. The likelihood is that dissidents nominating fewer candidates than seats will specify which board-nominated candidates they oppose and which they do not oppose.

Bylaw Amendments

The scope of bylaw amendments in response to the universal proxy rules should be considered in the context of a company's overall governance profile and structural defenses, but we recommend that all companies at least consider making the following changes:

- Requiring the dissident's nomination notice to include a representation that the dissident intends to solicit proxies from shareholders representing at least 67% of the voting power of shares entitled to vote on the election of directors;

- Requiring the dissident to comply with the universal proxy rules and to provide reasonable evidence thereof prior to the shareholder meeting; and

- Requiring the dissident to use a proxy card color other than white, which will be reserved for the company's exclusive use.

In addition, to the extent companies are considering updates to their advance notice bylaws, such amendments should be unambiguous and reasonably serve to provide the company and shareholders with relevant information. Bylaw updates adopted on a "clear day" will receive greater judicial and shareholder deference than changes adopted amid a proxy contest, and in light of the possibility of an increase in proxy contests in the years ahead, now may be a good time to review and update bylaws to reflect evolving market practices.

Proxy Season Engagement

The best preparation for any proxy contest occurs in peacetime, and companies should continue to build relationships and credibility with their investors in the context of their ongoing engagement meetings with investors for the benefit of all board members. Given the limited opportunities for directors to meet with investor stewardship teams during the year, companies should consider how to strike the right balance between introducing newer directors to investors and bringing familiar faces who are more experienced with shareholder engagement. Meeting agendas may also need review; additional time may need to be allocated to allow a robust discussion of board composition and effectiveness. During a proxy contest, it will be helpful if most or even, in certain circumstances, all directors are prepared to engage with key shareholders and proxy advisors.

Proxy Disclosures

As directors face more scrutiny and their roles become ever more complex, it may be time to take a closer look at proxy materials and related disclosures and processes, including D&O questionnaires, director skills matrices and director biographies. Heightened expectations regarding oversight of risk, climate, human capital, cybersecurity and other issues have led to growing investor and regulatory demand for disclosures, as evidenced by the SEC's recent rulemaking and comment letters. The director skills matrix provides companies an opportunity to communicate and explain the specific substantive skills they believe are critical to the business and the order of priority given to such skills. A well-crafted director skills matrix can effectively highlight the strength of the company's overall board composition and demonstrate the contribution each director brings to the board. Director biographies can also be leveraged to support the case for each director, highlighting particularly relevant or valuable aspects of their experience.

Board Composition and Refreshment

While dissidents will still need to make the case for change to secure the support of shareholders and proxy advisors, directors who are publicly perceived as having vulnerabilities such as lacking independence, having long tenure, being "overboarded" or just underperforming will face greater scrutiny, and likely face a higher risk of defeat in a proxy contest. Whereas in the past, companies have been able to successfully focus on the *collective* strength of the board, ISS has already indicated that it "will continue to highlight to clients those nominees from either party who, during our engagements, appear particularly well-qualified." In preparation for future proxy contests, in addition to providing clarity on strategic and business priorities, boards may need to further refine their approaches to board refreshment and composition (along with director training and education), including paying particular attention to concerns regarding long tenure, overboarding, diversity and relevant expertise and skillsets. In the universal proxy era, shareholders and proxy advisors may be more focused on the individual qualities and skill sets of the director candidates from each side.

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Universal proxy marks a new phase of corporate governance. A direct consequence of the rules is increased scrutiny of individual directors and their role on the board. In addition to bylaw amendments to ensure clear understanding of the voting process and timely compliance with the new rules, companies should also look to leverage public and private opportunities to build investor confidence and trust in the board as a whole as well as each member of the board.

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October 20, 2022

Antitrust Division Actively Seeking to Break up Corporate Interlocks

The Department of Justice's Antitrust Division ("DOJ") indicated in April that it was "ramping up efforts" to enforce Section 8 of the Clayton Act ("Section 8"), a statute prohibiting officers and directors from simultaneously serving with competing companies. DOJ announced initial results of those efforts in a press release yesterday, noting that directors of several companies had resigned as a result of its inquiries. DOJ's release says that the interlocks were only "alleged" and is careful not to state that the resigning directors and associated companies had actually violated the statute.

Section 8 prohibits competing companies from sharing officers and directors. The statute is intended to foreclose opportunities for competitors to collude illegally. There are certain *de minimis* safe harbors for interlocked companies whose competing sales are less than $4.1 million (as of 2022) or where the competing sales make up only a minimal percentage of total sales, as well as a one-year "grace" period to resolve a violation created by changed circumstances. No damages have ever been awarded under the statute, and there are no fines or penalties. Removal of the interlock typically remedies the situation, and director resignations from one board seem to have resolved the matters in DOJ's release.

DOJ appears to have established an internal task force dedicated to enforcing Section 8. Several companies have recently received civil investigative demands probing interlocks with extensive document and interrogatory requests. We expect more press releases and consent decrees to be forthcoming.

Private equity sponsors are a particular enforcement target. Perhaps the most striking aspect of DOJ's release is the treatment of PE firm Thoma Bravo and its investments in Dynatrace and Solarwinds. In that instance, three Thoma Bravo directors resigned from Solarwinds even though only one was also a director at Dynatrace. In Solarwinds' Form 8-K announcing the resignations, Thoma Bravo itself was deemed to be interlocked and Thoma Bravo as an institution announced its resignation from Solarwinds. This theory of corporate deputization, which focuses on the firm rather than specific individual interlocks at portfolio company boards, raises particular concerns for sponsors with multiple investments in one industry.

Companies should take the present opportunity to review their board memberships for potential competitor interlocks in light of DOJ's enforcement priorities.

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October 17, 2022

Cryptoassets and the SEC's Mandate

In recent months, the SEC has been the subject of intensifying criticism regarding its role in cryptoasset regulation. While some critiques properly raise questions and engage in constructive debate, others have resorted to shrill attacks that betray a reflexively adversarial position toward any agency involvement in the cryptoasset space. We continue to maintain that far greater regulatory clarity is indispensable to sustainable growth in the cryptoasset industry. While we do not believe that such clarity comes from civil enforcement actions that are lodged against ancillary players with limited transparent analysis, it is just as important that public debate about the terms of cryptoasset oversight not categorically disparage all SEC action in this space. There are key questions that require solutions and the cryptoasset industry and its investors ultimately stand to benefit from the SEC leadership's stated commitment to discharge its historic investor protection mandate in this arena despite its novel technology. This memo, it bears noting, does not necessarily reflect the views of our clients or our firm. Rather, it reflects the views of a specialized Crypto Team that we have formed in order to focus on the rapidly changing issues generated by the cryptoasset industry.

A central challenge confronting the SEC (and other agencies) is that cryptoassets' transformative potential raises significant risks to retail investors without adapted regulatory guardrails. Both the recent downturn in overall cryptoasset prices and substantial losses resulting from hacks and protocol security failures have made this painfully clear. While we express no view here as to whether any particular cryptoasset is a security, there are at least some circumstances where that analysis is relatively uncomplicated — and where existing SEC guidance has had a salutary effect. In particular, there are still circumstances where manifestly centralized project teams raise capital from the U.S. public in consideration for tokens and use the proceeds to develop a network or platform, while touting the tokens as an attractive investment whose value derives from that network or platform. The SEC provided clear guidance that such a fact pattern constitutes a securities offering in its 2017 *Munchee* order. Moreover, some SEC actions over the last year, like the settlement with BlockFi concerning its centralized cryptoasset yield-bearing product, have anticipated market vulnerabilities that have otherwise wrought harm to thousands of investors, as evident in particular in the bankruptcies of Celsius and Voyager. And the SEC has been continually vigilant in combatting fraud, from which the cryptoasset industry is not immune.

At the same time, we believe increased regulatory clarity in key areas remains necessary. For instance, we encourage the SEC to follow through on Chairman Gensler's acknowledgment that tailored disclosures may be appropriate with respect to whichever cryptoassets are properly deemed securities. Further consideration is also required as to whether cryptoassets that lack any indicia of equity or debt (as opposed to the arrangements by which they are sold) constitute securities. We also maintain our call for the SEC to provide more prescriptive guidance and/or no-action relief for industry leaders who are acting in good faith to comply with rules oriented toward traditional "centralized" securities that do not squarely fit cryptoassets (such as transfer agent rules). Lastly, we continue to believe there is a place for enhanced legislative clarity and global coordination, where appropriate. Legislative action could clearly define the oversight responsibilities with respect to the spot markets and the issuance of stablecoins (particularly if such stablecoins are not issued by regulated banks or trust companies). In the competitive and

inherently borderless global marketplace for cryptoasset projects, the U.S. agencies, including the SEC, should consider solutions proffered by foreign jurisdictions, such as the European Union's nascent "Markets in Crypto-assets" regulation.

A pillar of U.S. economic prosperity is the recognition that while investors should be able to risk their capital in a free market, they should have the benefit of protection in the form of regimented disclosure from an enterprise's operators so that they can make informed investment decisions, and that the market should be operated in an orderly and fair manner. While this paradigm will not fit every cryptoasset, there are many for which a careful evaluation of its basic premise is warranted. That inquiry hinges on thoughtful input from crypto industry leaders and transparent analysis by the SEC and other regulators, all of which can arise only from sustained constructive dialogue.

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September 22, 2022

Federal Court Denies Antitrust Division's Challenge to UnitedHealth Acquisition of Change Healthcare

Earlier this week, the U.S. District Court for the District of Columbia denied the Department of Justice's motion to enjoin UnitedHealth Group Inc.'s proposed acquisition of Change Healthcare Inc., a deal announced in January 2021.

Change operates a clearinghouse exchanging claims data between health insurers and healthcare providers, and also provides claims editing software and services to insurers. UnitedHealth is the largest health insurer in the United States and offers a competing claims editing solution.

In February 2022, the Antitrust Division challenged the proposed acquisition, alleging the transaction would (1) eliminate horizontal competition between Change and UnitedHealth for the sale and provision of claims editing solutions, (2) give UnitedHealth access to and the incentive to misuse other insurers' claims data, stifling competition and limiting innovation in the sale of health insurance to national accounts and large group employers, and (3) give UnitedHealth the ability and incentive to withhold or delay new Change innovations from competing health insurers. In January, soon before the Division filed its complaint, UnitedHealth announced its intent to divest Change's claims editing business, and, prior to trial, UnitedHealth entered into a definitive agreement to sell the business to TPG Capital. Although the divestiture eliminated the horizontal overlap between the parties, the Antitrust Division argued that the divested business would nonethless be weaker and less competitive than it is today.

Judge Nichols' practical, thorough opinion squarely rejected each of the Division's claims of competitive harm. With respect to the Division's horizontal claim, the Court concluded that the Division failed to show that the proposed merger is likely to substantially lessen competition in the relevant market because the trial evidence shows that competition for claims editing — *accounting for the divestiture* — will match, and perhaps even exceed, current levels.

The Court further rejected the Division's data misuse concerns as too speculative, noting that the potential competitive harm alleged is dependent on UnitedHealth "uproot[ing] its entire business strategy and corporate culture; intentionally violat[ing] or repeal[ing] longstanding firewall policies; flout[ing] existing contractual commitments; and sacrific[ing] significant financial and

reputational interests," and citing a dearth of "real-world evidence that United's rivals are likely to innovate less out of fear that United will poach their data." The Court similarly dismissed the concern that UnitedHealth will have the ability and incentive to withhold or delay future Change innovations, noting that (1) the products that UnitedHealth allegedly would be incented to withhold are merely conceptual, not actual products, and (2) withholding such innovations would be inconsistent with UnitedHealth's past practices.

Although the Division may appeal, and could even seek to enjoin the consummation of the deal pending appeal, the Court's decision demonstrates the challenges that the U.S. antitrust agencies face as they pursue their stated goal of more aggressive enforcement, particularly with respect to non-horizontal theories of competitive harm. For merging parties, the case and decision demonstrate both the challenges of the current regulatory environment for M&A — greater potential for prolonged regulatory delay (in this case nearly two years) and increased litigation risks — and that resolute transacting parties willing to test the agencies' non-traditional theories of harm may prevail in the courts.

The decision is especially notable in view of the agencies' recent statements, including remarks made by Deputy Assistant Attorney General Andrew Forman of the Antitrust Division earlier this week, which reference a heightened bar for accepting parties' divestiture and other settlement proposals. In this case, the parties successfully "litigated the fix," persuading Judge Nichols that the proposed divestiture — which the Antitrust Division had rejected as inadquate — sufficiently addressed the competition concerns of an otherwise unlawful combination. The decision is a reminder that the federal courts may have the last word on merger remedies.

Given the current regulatory environment, it is more important than ever that parties get legal advice on antitrust analysis, risk and strategy at the very outset of any possible transaction. Thoughtful and well-executed regulatory strategies will shorten investigations and maximize the chances of a deal's successful closing.

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Risk Management and the Board of Directors

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September 2022

Risk Management and the Board of Directors

I. INTRODUCTION

Overview

As companies seek to navigate a multi-stakeholder global landscape and the world continues to adjust to the impacts of Covid-19, significant new risks have emerged that are reshaping the near-term business and risk landscape. These new risks—and the intensification of longstanding risks—are pressure-testing the agility and resilience of corporate strategies, risk management systems and practices. The pandemic accelerated technological disruptions and business model changes and exposed sharp differences in the impacts felt by different sectors, with some experiencing enormous dislocation and others doing remarkably well and arguably emerging stronger. Looking ahead, all sectors of the economy are facing macroeconomic headwinds, including persistent inflation, surging interest rates, continued supply-chain bottlenecks and commodity shortages, all occurring amid the backdrop of the war in Ukraine, China's zero-Covid policy and growing geopolitical tensions. Severe drought, heatwaves and flooding across the globe have highlighted the burgeoning challenge of climate risks, which, along with the tight labor market and declining fertility rates across the developed world, present near- and longer-term risks that will require significant planning. Cybersecurity also continues to be a significant threat with regulators stepping up focus in step with growing geopolitical risks. In the United States, the 2022 midterms and ongoing political polarization continue to create uncertainties and surprises that companies will need to prepare for and address.

More than two-thirds of organizations surveyed by the American Institute of Certified Public Accountants ("AICPA") noted that perceived risk volumes and complexities remain elevated as companies across all sectors continue to deal with the litany of risks noted above. Surveyed organizations also recognized a "need for real change in how organizations govern business continuity and crisis management" in light of growing pressures from stakeholders for more disclosure about risks and heightened demands on management and boards to enhance effective risk management and preparedness for unexpected risk events. The World Economic Forum's Global Risks Report 2022 highlighted the economic and societal ramifications of the Covid pandemic, noting that domestic and global fragmentation may worsen the pandemic's impacts and complicate the coordination needed to tackle the challenges ahead.

The disparate and newly emerging risks facing companies today call for boards and management to reassess and update their organization's risk profile and vulnerabilities, evaluate the maturity and robustness of risk management processes and policies, and integrate risk management into strategic decision-making.

Managing corporate risk is not simply the business and operational responsibility of a company's management team—it is a governance issue that is squarely within the oversight responsibility of the board. Courts and regulators are increasingly scrutinizing the presence and effectiveness of board-level risk oversight systems, as well as the adequacy of public disclosures and quality of board responses when crises erupt. Recent *Caremark* decisions from the Delaware Court of Chancery have continued to influence the risk governance landscape. And

pressure is coming from other sources, including an emerging wave of "anti-woke" investors, state legislatures and state attorneys general campaigning for a rollback of recent efforts to address ESG-related risks, including climate change.

This guide highlights critical risk-management issues and provides updates on Delaware law governing director liability—including developments that highlight the importance of active, engaged board oversight of corporate risk and maintaining appropriate records of that oversight. Key topics addressed in this guide are:

- the distinction between risk oversight and risk management;
- tone at the top and corporate culture as components of effective risk management;
- recent developments in Delaware law regarding fiduciary duties and other legal frameworks;
- third-party guidance on risk oversight best practices;
- institutional investor focus on risk matters;
- specific recommendations for improving risk oversight;
- U.S. Department of Justice guidance on the design of compliance programs;
- special considerations pertaining to ESG and sustainability-related risks, including the emerging pushback from certain investors and state regulators; and
- special considerations regarding cybersecurity, ransomware and data privacy matters.

Risk Oversight by the Board—Not Risk Management

Both the law and practicality continue to support the proposition that boards cannot and should not be involved in day-to-day risk *management*. However, as recent legal developments make clear, every board's *oversight* role should include active engagement in monitoring key corporate risk factors, including through appropriate use of board committees. These board-level monitoring efforts should be documented through minutes and other corporate records.

Directors should—through their risk oversight role—require that the CEO and senior executives prioritize risk management and integrate risk management into strategic decision-making. Directors should satisfy themselves that the risk management policies and procedures designed and implemented by the company's senior executives and risk managers are consistent with the company's strategy and business purpose; that these policies and procedures are functioning as directed; and that necessary steps are taken to foster an enterprise-wide culture that supports appropriate risk awareness, behavior and judgments about risk, and that recognizes and appropriately addresses risk-taking that exceeds the company's determined risk appetite. The board should be familiar with the type and magnitude of the company's principal risks, as well as new and emerging risks, especially concerning "mission critical" areas for the business and the sector, and should be kept apprised periodically of the company's approach to

identifying and mitigating such risks, instances of material risk management failures and action plans for mitigation and response. Directors may also need to consider the appropriate allocation of oversight responsibilities among the board and its committees, including whether dedicated ad hoc or formal committees may be necessary to focus oversight on particular risks. In prioritizing such matters, the board can send a message to management and employees that comprehensive risk management is an integral component of strategy, culture and business operations.

Tone at the Top and Corporate Culture as Key to Effective Risk Management

Covid-19 strained many companies and highlighted the critical importance of ensuring that the board and relevant committees work with management to set the appropriate "tone at the top" by promoting and actively cultivating a corporate culture that meets the board's expectations and aligns with the company's strategy. The lessons from the pandemic still ring true today where boards are expected to not only help steer companies through the complex economic environment, but also serve as a sounding board for the company's positioning on social and political issues of importance to the company's various stakeholders—employees, customers, suppliers and stockholders—whose views on these issues are not always aligned. In setting the appropriate tone at the top, transparency, consistency and communication are key.

The board's vision for the corporation should include its commitment to risk oversight, ethics, good corporate citizenship and avoiding compliance failures, and this commitment should be communicated effectively throughout the organization. It is particularly important that the messaging from the board promptly adapts and responds to salient challenges; prolonged silence and/or board inaction to "get ahead" of key risks can harm a company's relationships with stakeholders and tarnish its reputation and brand image. This is particularly the case in a tight labor market that is transitioning to a new generation of employees and consumers who are scrutinizing corporate purpose and behavior. Cases in point include those instances where employee safety and well-being are concerned and at companies and industries where product or service failures can jeopardize consumer or environmental safety, critical infrastructure or human life. The corporate culture should not prioritize cost-cutting or profits (which may include, as a matter of employee and public perception, compensation levels) over safety and compliance. In the 2022 AICPA report, 44% of organizations cited competing priorities as a barrier to effective enterprise risk management.

Continued developments, including shareholder pressure to promote accountability and progress on diversity, equity and inclusion ("DEI") initiatives, also underscore the importance of setting the appropriate tone at the top. Discrimination and harassment can have a devastating impact both on the employees impacted by such behavior and on broader corporate culture, employee morale and retention, consumer preferences and the reputation of the company and its board and management personnel. Delayed or indecisive responses to sexual misconduct or gender or racial discrimination can often be as damaging to a company as the misconduct itself. Similarly, ensuring an inclusive workplace environment is central to employee morale and a motivated workforce.

With respect to these and other critical risks, the board should work with management to consider developing a crisis response plan that includes the participation of human resources officers, public relations advisors and legal counsel. The use, scope and design

of preventative corporate policies, including training and educational programming, related to conduct and reporting expectations should also be carefully considered, as should potential implications, enforcement, remedies and application in the event of a violation once such policies are adopted. Disclosure of board-level participation in these deliberations also may be key to demonstrating to internal and external audiences the seriousness of these policies.

Promoting Board Readiness for Current and Future Risk Oversight

The evolution of risks has accelerated following the pandemic, requiring boards to take a more active approach in ensuring directors have the skills to effectively oversee a company's pressing and emerging risks. Edelman's 2022 Trust Barometer found that most surveyed respondents ranked business ahead of NGOs, the media and the government (which ranked last) to take leadership and address societal issues. The same survey reported that most respondents bought brands, chose their workplace and made investments based on their beliefs and values. Stakeholder perceptions of companies as social and political actors have influenced practices and approaches on board composition and refreshment and have expanded the substantive responsibilities of boards.

The National Association of Corporate Directors' report "Fit for the Future" published in 2019 noted that director recruitment continues to prioritize "classic skills and experiences," such as executive leadership and finance, while under 5% of directors have experiences in emerging focus areas such as human capital and cybersecurity. Today, the trend has begun to pivot in recognition that boards need to be educated and counseled to effectively deal with broader strategic and stakeholder imperatives, cybersecurity and significant ESG risks that could impact the company. Stakeholders, including key investors, regulators and third-party disclosure frameworks, are actively calling for companies to disclose the scope and nature of such expertise on their boards, in addition to enhancing functional corporate-level capabilities.

To prepare for such risks, boards must engage in director training to build on existing skills and leverage management and advisor expertise to develop deep working knowledge of key emerging issues. In addition, the recruitment of new directors will need to address any potential knowledge, skill and background gaps. While some companies may decide it is necessary to seek directors with climate, cybersecurity or human capital experience, many others may conclude that it is more appropriate to further educate existing board members. And as expectations around corporate involvement, leadership and activism grow, boards will also need to be prepared to assume a more public-facing role on key issues, including being prepared to engage with stakeholders beyond the traditional corporate engagement cycle.

II. SOURCES OF RISK OVERSIGHT OBLIGATIONS OF THE BOARD OF DIRECTORS

Although institutional investors, legislators and other constituencies have varying expectations concerning board risk oversight responsibilities, the core responsibilities are grounded principally in state law fiduciary duties, federal and state laws and regulations, stock exchange listing requirements and certain established (albeit evolving) best practices. Recent Delaware decisions highlight the heightened expectations for a developed record of oversight on a variety of risks and the importance of making a good faith effort to put in place a compliance system designed to help ensure that their companies operate within the bounds of the law and

that their products, services, and operations do not cause harm to consumers, community members, or the environment.[1]

Fiduciary Duties

The Delaware courts have taken the lead in formulating legal standards for directors' risk oversight duties, particularly following *In re Caremark International Inc. Derivative Litigation*, the seminal 1996 decision addressing director liability for the corporation's failure to comply with external legal requirements. Delaware courts in the *Caremark* line of cases have held that directors can be liable for a failure of board oversight only where there is "sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists" or a culpable failure to monitor an existing system resulting in a disregard of a pattern of "red flags." Delaware Court of Chancery decisions in the decades following *Caremark* regularly dismissed shareholder suits claiming such a total failure of oversight responsibility. *See*, for example, our memos discussing *In re The Goldman Sachs Group, Inc. Shareholder Litigation* (2011), *Oklahoma Firefighters Pension & Retirement System* v. *Corbat* (2017) and *City of Birmingham Retirement and Relief System* v. *Good* (2017).

More recent rulings, however, show that the risk of exposure for failure of oversight is real, and that courts are willing to permit shareholder claims alleging breaches of fiduciary duty by directors to proceed where the complaint alleges with specificity that the board ignored red flags reflecting underlying compliance, safety, reporting or other risks or that the board gave insufficient attention to such matters, despite the existence of company-wide policies and procedures on the topic. These decisions have accepted well-pled claims that boards failed to act in good faith to maintain board-level systems for monitoring mission-critical functions, such as product safety, pharmaceutical trial testing and financial reporting. A history of unaddressed deficiencies or a failure by the company to come forward with books and records evidencing meaningful board-level oversight has been among the chief aggravating factors driving these judicial decisions. *See, e.g.*, *Hughes* v. *Hu*; *Marchand* v. *Barnhill* (Bluebell Creameries); *In Re Clovis Oncology Inc. Derivative Litigation*.

Last year, the Delaware Court of Chancery in *In Re The Boeing Company Derivative Litigation* permitted a *Caremark* duty-of-oversight claim to proceed against the directors of the Boeing Company after concluding that the complaint described a board that "complete[ly] fail[ed] to establish a reporting system for airplane safety." Emphasizing that meeting minutes gave little sign of director engagement with safety issues, the court credited allegations that the board had no committee charged with direct responsibility to monitor airplane safety, seldom discussed safety, and had no protocols requiring management to apprise the board of safety issues. The court further determined that Boeing's board "turn[ed] a blind eye to a red flag representing airplane safety problems," citing allegations that the directors

[1] Delaware courts in the *Caremark* line of cases have pointed to the absence of exculpatory documentation produced in response to a stockholder's inspection demand as evidence that the directors "face a substantial likelihood of liability" for "failing to act in good faith to maintain a board-level system for monitoring the Company's financial reporting." *Hughes* v. *Hu*, 2020 WL 1987029, at *17 (Del. Ch. Apr. 27, 2020).

"treated the [first 737 MAX] crash as an 'anomaly,' a public relations problem, and a litigation risk, rather than investigating the safety of the aircraft."

By contrast, in *Firemen's Retirement System of St. Louis* v. *Sorenson*, the Court of Chancery dismissed a derivative claim seeking to hold the directors and officers of Marriott International liable for a data breach that affected millions of guests, concluding that the allegations failed to demonstrate that the directors had "completely failed to undertake their oversight responsibilities, turned a blind eye to known compliance violations, or consciously failed to remediate cybersecurity failures." The court also reaffirmed that "the difference between a flawed effort and a deliberate failure to act is one of extent and intent"—with a *Caremark* claim requiring the latter. The court did warn, however, that high risk of cybersecurity threats "increasingly call[s] upon directors to ensure that companies have appropriate oversight systems in place," and that "corporate governance must evolve to address" these risks. Earlier this year, the Court of Chancery further underscored the utility of board risk management and compliance structures when it dismissed breach of fiduciary duty claims against the board of NiSource in *City of Detroit Police and Retirement Sys.* v. *Hamrock* on the grounds that the company had a board-level committee specifically charged with addressing the core risks posed by its business—including the risks of explosion. Breach of fiduciary duty claims brought against the board of SolarWinds were also dismissed recently for similar reasons.

Whether such lawsuits lead to findings of liability will often turn on whether the targeted company can persuade a court that it had in place control and monitoring functions commensurate with the scope and scale of the potential risk. Once a *Caremark* claim survives a pleadings motion, however, it becomes a vehicle for extensive discovery and takes on substantial settlement value, even if not meritorious.

Ultimately, the events preceding oversight litigation illustrate that risk cannot be contained entirely. Corporate trauma can happen, even to the best-run companies, and courts can be expected to permit multiple avenues of litigation attack when it does. The best approach is for boards to undertake regular review of mission-critical corporate operations and developments affecting enterprise-level risk. As important, boards and their advisers should create a clear written record of their review and their vigilant response to any compliance risks that may emerge, such that inspecting stockholders and reviewing courts will have a fair picture of directors' work. Boards that institute and document such regular reviews will be in accord with best practices for corporate risk management. In the litigation context, boards will have a powerful answer, available at the pleading stage, if ever charged with neglecting their oversight duties.

SEC Risk Disclosure Rules

The SEC requires companies to disclose the board's role in risk oversight, the relevance of the board's leadership structure to such matters and the extent to which risks arising from a company's compensation policies are reasonably likely to have a "material adverse effect" on the company. A company must further discuss how its compensation policies and practices, including those of its non-executive officers, relate to risk management and risk-taking incentives. Upcoming SEC rulemakings will likely continue to seek to expand expectations and disclosures concerning cybersecurity, climate change, human capital management and other ESG

and sustainability-related matters. Recent SEC comment letters issued to companies in Fall 2022 have asked for enhanced 2023 proxy statement disclosures by companies that would provide more company-specific detail on the board's role in risk oversight and the relationship between the board's leadership structure and risk management matters..

On a more granular level, the SEC requires companies to disclose in their annual reports "factors that make an investment in [a registrant's securities] speculative or risky." This expansive directive was until a few years ago accompanied by risk factor examples set forth in Item 503(c) of Regulation S-K (now Item 105), but the SEC eliminated those specific examples out of concern that they were encouraging "boilerplate" disclosures of limited value to investors. In August 2020, in furtherance of its "principles-based approach" to risk factor disclosure, the SEC adopted rule amendments to Item 105, noting that the amendments are designed to "result in risk factor disclosure . . . more tailored to the particular facts and circumstances of each registrant" and reduce use of "generic risk factors." Thus, companies must now disclose, in a concise and logical fashion, the most significant risks and explain how each factor affects the company's business and securities. In September 2021, the SEC released a sample letter with requests it may make of companies to ensure compliance with SEC guidance on climate-related disclosure, and the staff has proceeded to issue a number of climate-related comment letters in recent months, focusing on issues of climate risk disclosure and mitigation efforts.

The SEC earlier this year proposed amendments to Regulations S-K and S-X to require new climate-related risk disclosures. If adopted, the proposed rules would significantly expand upon the SEC's 2010 climate guidance, which called on companies to disclose material climate change-related risks and opportunities in their description of business, legal proceedings, risk factors, and MD&A. Certain aspects of the proposed climate rules have drawn extensive requests for scaling back and mixed commentary and so may be modified, and, if they are ultimately adopted by the SEC, they will likely face litigation challenges depending on the scope of the final rules. Nevertheless, well-managed companies should keep these proposals in mind, because they contemplate domestic and foreign issuers disclosing, in registration statements, annual reports and audited financial statements, information on board and management climate-related risk oversight and governance, material climate-related risks and opportunities over the short-, medium- and long-term, Scopes 1 and 2 greenhouse gas emissions, impact of climate-related events on line items of audited financial statements, and climate-related targets, goals and transition plans (if any). Accelerated and large accelerated issuers would also be required to provide third-party attestation on their Scopes 1 and 2 disclosures, and, in certain cases, their Scope 3 emissions over time. The proposed rules will, if adopted, generally be phased in over the three years beginning 2023 for large accelerated filers; "smaller reporting companies" would be exempted from Scope 3 disclosures. Notably, the requirement for climate-related line items in audited financial statements will come within the scope of a registrant's internal control over financial reporting. Climate-related disclosures within registration statements, including information filed in annual reports and incorporated by reference, will also be subject to liability provisions under the Securities Act of 1933 but will be afforded protections under the forward-looking safe harbors pursuant to the Private Securities Litigation Reform Act ("PSLRA") (except disclosures made in an initial public offering registration statement to which the PSLRA does not extend). Additionally, all material public climate-related disclosures are subject to the liability provisions of Section 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934.

Stock Exchange Rules

New York Stock Exchange ("NYSE") corporate governance standards impose certain risk oversight obligations on the audit committee of a listed company. Specifically, while acknowledging that "it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk," the NYSE requires that an audit committee "discuss guidelines and policies to govern the process by which risk assessment and management is undertaken." These discussions should address major financial risk exposures and the steps management has taken to monitor and control such exposures, including a general review of the company's risk management programs. The NYSE permits a company to create a separate committee or subcommittee to be charged with the primary risk oversight function as long as the risk oversight processes conducted by that separate committee or subcommittee are reviewed in a general manner by the audit committee and the audit committee continues to discuss policies with respect to risk assessment and management.

Dodd-Frank

The Dodd-Frank Act created new federally mandated risk management procedures principally for financial institutions, requiring bank holding companies with total assets of $10 billion or more, and certain other non-bank financial companies, to have a separate risk committee that includes at least one risk management expert with experience managing risks of large companies.

Third-Party Guidance on Best Practices

Various industry-specific regulators and private organizations publish suggested best practices for board oversight of risk management. Example frameworks that have been used to inform internal enterprise rise management ("ERM") processes include guidance published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the "Three Lines Model" published by the Institute of Internal Auditors, ISO 31000 published by the International Organization for Standardization, as well as guidance periodically issued by the National Association of Corporate Directors ("NACD") and the Conference Board.

In 2017, COSO released its updated internationally recognized enterprise risk management framework. The updated framework consists of five components: (1) Governance and Culture (the tone of the organization, which reinforces the importance of enterprise risk management and establishes oversight responsibilities for it); (2) Strategy and Objective-Setting (the integration of enterprise risk management into the organization's strategic plan through the process of setting strategy and business objectives); (3) Performance (the identification and assessment of risks that may impact achievement of strategy and business objectives); (4) Review and Revision (the review of the organization's performance, which allows for consideration of how well the enterprise risk management components are functioning and what revisions are needed); and (5) Information, Communication and Reporting (the continual, iterative process of obtaining information, from both internal and external sources, and sharing it throughout the organization).

Recognizing that calls for identifying and mitigating ESG risks have become increasingly urgent, COSO, in conjunction with the World Business Council for Sustainable Development, released guidance in 2018 for applying enterprise risk management to ESG-related risks. This guidance recognizes that companies "face an evolving landscape of environmental, social and governance (ESG)-related risks that can impact their profitability, success and even survival" and that such risks have "unique impacts and dependencies." Notably, the guidance reaches social-related risks encompassing stakeholder opposition, supply chain matters, human capital and labor-related issues and the complex area of maintaining "'social license' to operate." The guidance offers an enterprise risk management approach that runs from governance to risk identification and assessment through to communication and reporting. COSO is currently also developing supplemental guidance to its internal controls frameworks, with focus on sustainability reporting for internal decision-making and external public reporting.

COSO released additional guidance in November 2020 regarding the nexus between enterprise risk management and compliance risk management. The guidance aims to address management of risks related to adhering to specific laws and regulations, as well as adjacent risks related to compliance with professional standards, internal organizational policies and contractual obligations. Importantly, it acknowledges that compliance risks may arise not only from insider action—of directors, management and employees—but also third parties such as suppliers, outside sales representatives and contractors. COSO has also issued still more guidance on how to apply its enterprise risk management framework to emerging areas including guidance released in September 2021 to help organizations apply the COSO framework and principles to implement and scale artificial intelligence and guidance released in February 2022 to help companies manage enterprise risks in a fast-changing business environment.

In July 2020, the Institute of Internal Auditors ("IIA") released an update to its "Three Lines of Defense" model in risk management, now named the "Three Lines Model," to reflect a reorientation from defending against risk toward value creation and prospective risk management. Under the prior version of the model, (1) management control was the first line of defense, (2) various risk control and compliance oversight functions established by management were the second line of defense, and (3) independent assurance was the third line of defense. The updated model incorporates the governing body, typically the corporate board, and makes it accountable to stakeholders for organizational oversight. In addition, the model's departure from the strict "three lines" approach highlights the need for collaboration and communication between the governing body, management and internal audit functions.

In early 2018, the International Organization for Standardization released an update to ISO 31000, an international standard that provides widely applicable guidelines and principles for risk management for a range of organizations. The risk management framework is composed of five areas—integration, design, implementation, evaluation and improvement—and centered around a sixth area, leadership and commitment involving senior management and oversight bodies. The principles of ISO 31000, which provide guidance on the characteristics of effective and efficient risk management and serve as the foundation of managing risk, include: continual improvement, integrated, structured and comprehensive, customized, inclusive, dynamic, best available information, and human and cultural factors. And ISO 31000's risk management process involves the systematic application of policies, procedures and practices to

the activities of communicating and consulting, establishing the context and assessing, treating, monitoring, reviewing, recording and reporting risk.

COSO, IIA and ISO 31000, as well as other frameworks outlining risk-related best practices, underscore that risk oversight and risk management should not be treated as isolated, defensive functions, but rather should be proactively integrated into strategic planning and prioritized as part of board- and CEO-level governance and oversight.

III. CONTINUED STRONG INVESTOR FOCUS ON RISK MANAGEMENT

Institutional Investors

Risk oversight is a top governance priority of institutional investors. In recent years, investors have pushed for more meaningful and transparent disclosures on board-level activities and performance with respect to risk oversight. As noted in the NACD's Blue Ribbon Commission report on disruptive risks, investors "keep raising the bar for boards on the oversight of everything from cybersecurity to culture, and the notion of companies' license to operate is now front and center." The growing investor pressure in this area has prompted SEC rulemaking specifically targeted at addressing climate and cybersecurity risks and comment letters to companies seeking clarity on the scope and rationale behind climate risk disclosures. The pressure is also being felt during the proxy season where institutional investors have lent their support to shareholder proposals calling for greater disclosures on a range of material, business, operational, human capital, environmental, social and sustainability-related risks.

Major institutional investors such as BlackRock, State Street and Vanguard, as well as actively managed funds, believe that sound risk oversight practices are key to enhancing long-term, sustainable value creation, and have emphasized oversight and monitoring of sustainability-related risks, as well as other business risks. BlackRock has stated that it "look[s] to the board to articulate the effectiveness of these mechanisms in overseeing the management of business risks and opportunities and the fulfillment of the company's purpose." Specifically, BlackRock expects boards to oversee the identification and management of material business operational, and sustainability-related risks and the robustness of a company's ERM framework as well as address business issues, including environmental and social risks and opportunities, when they have the potential to materially impact the company's long-term value, and may vote against directors that it deems responsible for particular inadequacies.

State Street has likewise stated that it believes the primary responsibility of the board is to preserve and enhance shareholder value and protect shareholder interests. State Street expects boards to monitor the risks that arise from a company's business, including with respect to sustainability, and has noted that "good corporate governance necessitates the existence of effective internal controls and risk management systems, which should be governed by the board." An area of specific focus is risks relating to DEI, which State Street expects companies to "effectively manage and disclose." For S&P 500 companies, State Street will act against the chair of the nominating committee if a company does not disclose the gender, racial and ethnic composition of its board or have at least one director from an underrepresented community. In addition, State Street has also developed its proprietary R-Factor scoring system which encourages companies to manage and disclose material, industry-specific ESG risks and which

State Street uses to determine whether to take voting action against the lead independent director of companies it deems "laggards."

Vanguard has said that it views directors as "responsible for effective oversight and governance of their companies' most relevant and material risks." In its 2022 proxy voting policy for U.S. portfolio companies, Vanguard stated that "[b]oards should take a thorough, integrated, thoughtful approach to identifying, quantifying, mitigating, and disclosing risks that have the potential to affect shareholder value over the long term." Vanguard also expects boards to communicate their approach to risk oversight to shareholder through their normal course of business. Vanguard will vote against a director or committee for "material risk oversight failures," including failures regarding climate risk oversight.

Proxy Advisory Firms

In exceptional circumstances, scrutiny from institutional investors with respect to risk oversight can translate into shareholder campaigns and adverse voting recommendations from proxy advisory firms such as Institutional Shareholder Services ("ISS") and Glass Lewis. Both ISS and Glass Lewis will recommend voting "against" or "withhold" in director elections, even in uncontested elections, when the company has experienced certain extraordinary circumstances, including material failures of risk oversight.

In its 2022 Global Proxy Voting Guidelines, ISS states that it will, "[u]nder extraordinary circumstances, vote against or withhold from directors individually, committee members, or the entire board" for material failures of risk oversight. Examples of such failures include large or serial fines or sanctions from regulatory bodies; demonstrably poor risk oversight of environmental and social issues, including climate change; significant adverse legal judgments or settlements; or hedging of company stock. ISS has also focused attention on climate risk oversight failures, noting that it will vote against or withhold from the incumbent chair of the responsible committee (or other directors on a case-by-case basis) where it determines that the company is not taking the minimum steps needed to understand, assess, and mitigate risks related to climate change to the company and the larger economy. Such minimum steps include providing disclosures aligned with the recommendations of the Task Force on Climate-related Financial Disclosures and setting GHG emissions reduction targets. ISS's voting policies will also generally vote in favor of shareholder proposals seeking risk disclosures on a broad range of topics. The ISS ESG Governance QualityScore—a data-driven scoring and screening tool that ISS and other institutional investors use to monitor portfolio company governance—also focuses heavily on boards' audit and risk oversight.

Glass Lewis revised its proxy voting guidelines to reflect its increased scrutiny on board oversight of environmental and social risks. Glass Lewis believes that "the board's role is to ensure that management conducts a complete risk analysis of company operations, including those that have material environmental and social implications." Glass Lewis expects to hold directors accountable where companies have "displayed disregard for environmental or social risks, have engaged in egregious or illegal conduct, or have failed to adequately respond to current or imminent environmental and social risks that threaten shareholder value." Risk areas that Glass Lewis believes necessitate management and oversight include environmental, social, regulatory, legal, reputation and governance. In addition, Glass Lewis has specifically noted

legal and reputational risks arising from poor conduct in foreign countries (such as bribery), gender pay inequity, human rights practices across the supply chain and issues arising from privacy, censorship, and freedoms of expression and access, and on a case-by-case basis will support shareholder proposals requesting further disclosures and action in these areas.

IV. RECOMMENDATIONS FOR IMPROVING RISK OVERSIGHT

The board should promote an effective, ongoing risk dialogue with management, design the right relationships across the board, its committees, management, and the workforce regarding risk oversight, and ensure that appropriate resources support risk management systems, compliance, and reporting mechanisms. While risk management should be tailored to the specific company and relevant risks, in general, an effective risk management system will: (1) adequately identify the material risks that the company faces in a timely manner; (2) adequately transmit necessary information to senior executives and, importantly, to the board or relevant board committees; (3) implement appropriate risk management strategies that are responsive to the company's risk profile, business strategies, specific material risk exposures and risk tolerance thresholds; (4) integrate consideration of risk and risk management into strategy development and business decision-making throughout the company; (5) feature regular reviews of the effectiveness of the company's risk management efforts, on a quarterly or semiannual basis; and (6) document the existence of risk management protocols and appropriate board-level engagement on risk matters.

Specific Recommendations

Below are specific actions the board and appropriate board committees should consider as part of their risk management oversight:

- review with management the categories of risk the company faces, including any risk concentrations and risk interrelationships, as well as the likelihood of occurrence, the potential impact of those risks, mitigating measures, reporting and monitoring and action plans to be employed if a given risk materializes;

- review with management the company's risk management monitoring and reporting processes, including whether these processes are sufficiently robust and holistic to encompass the company's most critical risks and whether there are internal silos of risks impacting particular aspects of the business that could coalesce into enterprise-wide issues;

- review with management the company's risk appetite and risk tolerance, its tools for measuring company-wide risks and assessing risk limits and whether the company's business strategy is consistent with the agreed-upon risk appetite and tolerance, taking into account feedback from management and stakeholders;

- review with management the primary elements comprising the company's risk culture, including establishing "a tone from the top" that reflects the company's core values and the expectation that employees act with integrity and promptly escalate instances of noncompliance, and steps to ensure effective communication of the company's risk management strategy throughout the organization and through appropriate public disclosures;

- review the company's director, executive and employee compensation structure and incentive programs to ensure they are appropriate in light of the company's articulated risk appetite and that these programs are creating incentives to encourage, reward and reinforce desired corporate behavior;

- review with committees and management the board's expectations as to each group's respective responsibilities for risk oversight and management to ensure a shared understanding as to roles and accountability, including the quality, format and cadence of management's risk reporting to the board and/or appropriate committees;

- review and reassess the allocation of board and committee oversight responsibilities with respect to the different categories of new and evolving risks the company faces, including consideration of whether to form ad hoc or subcommittees, where appropriate, to address particular risks; and

- review the skills, professional experiences and practices that are required by the board to effectively oversee risks, to assess whether the current board's mix of skills and professional experiences are sufficient and identify selection priorities to be used as part of the board recruitment and refreshment process.

The board should formally review, on at least an annual basis, the company's risk management system, including a review of board- and committee-level risk oversight policies and procedures and a presentation of "best practices" to the extent relevant, tailored to focus on the industry or regulatory arena in which the company operates. In the wake of the recent Delaware decisions green-lighting *Caremark* claims across a variety of industries, directors should also implement effective procedures to ensure that the board itself monitors key enterprise risk on an ongoing basis and properly documents this monitoring. To this end, it may be appropriate for boards and committees to engage outside consultants to assist them both in the review of the company's risk management systems and in understanding and analyzing business-specific risks. But because risk, by its very nature, is subject to constant and unexpected change, annual reviews cannot replace the need to regularly assess and reassess company operations and processes, learn from past mistakes and external events, and seek to ensure that current practices enable the board to address specific major issues whenever they may arise. Where a major or new risk event comes into focus, management should investigate and report back to the full board or the relevant committees as appropriate.

While fundamental risks to the company's business strategy are often discussed at the full board level, many boards continue to delegate primary oversight of risk management to the audit committee, which is consistent with the NYSE corporate governance standard requiring the audit committee to discuss risk assessment and risk management policies. In recent years, the percentage of boards with a separate risk committee has grown, but that percentage remains relatively low. According to a 2021 Spencer Stuart survey, only 12% of the companies surveyed had a standing risk committee. As discussed above, companies subject to Dodd-Frank are required to have a dedicated risk management committee. However, the appropriateness of a dedicated risk committee at other companies will depend on the industry and specific circumstances of the company. If the company keeps the primary risk oversight function within the audit committee, the audit committee should schedule periodic review of risk management

outside the context of its role in reviewing financial statements and accounting compliance. The potential for overload is real: a Deloitte survey of U.S. public companies found that 32% of audit committee respondents expect to spend more time on ERM risk oversight this coming year while also noting that committee responsibilities have expanded to encompass oversight of ESG reporting and disclosures.

Thoughtfully allocating responsibility for risk management and compliance among the board's committees also creates an opportunity for alignment of officer-to-board-level reporting relationships, which has the added value of ensuring that the directors get to know and regularly communicate with a broader range of corporate executives. In an era in which the number of insiders on a company's board is usually just one or two—generally the CEO and perhaps one additional director—board/management alignment gives the board direct insight into the company's operations and culture.

Any committee charged with risk oversight should hold sessions in which it meets directly with key executives primarily responsible for risk management. It may also be appropriate for the committee(s) to meet in executive session both alone and together with other independent directors to discuss the company's risk culture, the board's risk oversight function and key risks faced by the company. In addition, senior risk managers and senior executives should understand they are empowered to inform the board or committee of extraordinary risk issues and developments that require immediate board attention outside the regular reporting procedures. In light of the *Caremark* standards discussed above, the board should feel comfortable that it receives reports of red flags or "yellow flags," so that such issues may be investigated as appropriate.

Department of Justice Guidance on the Design of Effective Compliance Programs

As noted above, senior management should provide the full board or a relevant committee with an appropriate review of the company's legal compliance programs and how they are designed to address the company's risk profile and detect and prevent wrongdoing. While compliance programs should be tailored to the company's specific needs, the board and senior management of any company should establish a strong tone at the top that emphasizes the company's commitment to full compliance with legal and regulatory requirements, as well as internal policies.

This goal is particularly important not only to reduce the risk of misconduct, but also because a well-tailored compliance program and a culture that values ethical conduct are critical factors that DOJ will assess in considering whether to bring charges against a corporation in the event that corporate personnel engage in misconduct. Under the Principles of Federal Prosecution of Business Organizations, prosecutors are required to weigh, among other factors, the seriousness of the offense, the role (if any) of high-level management, the effectiveness of a company's compliance program at the time of the offense, the extent of cooperation and reporting, remedial measures taken and potential collateral consequences for innocent stakeholders. In addition, under DOJ's FCPA Corporate Enforcement Policy, which serves as non-binding guidance in all Criminal Division corporate fraud investigations, a company is eligible for an exercise of prosecutorial discretion in the company's favor—including a

declination of any prosecution—only if it has implemented an effective ethics and compliance program.

Late last year, DOJ announced an array of policy revisions that directly bear upon how boards and senior executives should manage risk. These announcements built upon updated guidance from June 2020 for white-collar prosecutors, which identified factors to be considered in evaluating corporate compliance programs, noting that prosecutors may "reward efforts to promote improvement and sustainability" of compliance programs in the form of any prosecution or resolution. DOJ further emphasized the need for a dynamic compliance program that makes use of data analytics and testing to review and address potential gaps in a company's compliance functions. In a major policy speech in October 2021, Deputy Attorney General Lisa Monaco announced that white-collar prosecutors would be encouraged to favor the imposition of a corporate monitor "[w]here a corporation's compliance program and controls are untested, ineffective, inadequately resourced, or not fully implemented at the time of a resolution" of a criminal investigation. To avoid the imposition of a monitor, companies should ensure that their "compliance program and controls are demonstrated to be tested, effective, adequately resourced, and fully implemented at the time of a resolution." These revised DOJ policies put a premium on the thoughtful design and implementation of genuinely effective compliance programs.

Directors should consider borrowing from the updated DOJ guidance by constructively posing many of the same probing questions that DOJ now expects federal prosecutors to ask. Those DOJ directives are aimed at understanding the same fundamental questions a well-informed director should want to understand: Is the company's compliance program well-designed, adequately resourced, drawing upon the right information and data, and effective at driving the right ethics and compliance messages throughout the organization? Management should be expected to provide the board or appropriate board committees with timely and complete answers to these kinds of questions, and do so periodically.

In keeping with DOJ's guidance, a compliance program should be designed by people with relevant expertise and will typically include interactive training as well as written materials. Compliance policies should be reviewed periodically to assess their effectiveness, to ensure they target the company's current compliance risks and to make any necessary changes. Policies and procedures should fit with business realities. A rulebook that looks good on paper but which is not followed will hurt, not help. There should be consistency in enforcing stated policies through appropriate disciplinary measures. Finally, there should be clear reporting systems in place both at the employee level and at the management level so employees understand when and to whom they should report suspected violations and so management understands the board's or committee's informational needs for its oversight purposes. A company may choose to appoint a chief compliance officer and/or constitute a compliance committee to administer the compliance program, including by facilitating employee education and issuing periodic reminders. If there is a specific compliance area that is critical to the company's business, the company may consider developing a dedicated compliance apparatus for it.

V. SPECIAL CONSIDERATIONS REGARDING ESG AND SUSTAINABILITY-RELATED RISKS

ESG risks have become a core area of risk oversight responsibility for the board. There is a growing consensus among investors and proxy advisors that ESG risks have the potential to significantly impact a company's long-term strategy and value creation, and consequently, boards need to oversee the monitoring, disclosure and management of such risks.

Heightened investor focus on ESG risks has also drawn the attention of regulators at home and abroad. On March 4, 2021, the SEC announced the creation of the Climate and ESG Task Force in the Division of Enforcement, to focus on identifying misstatements in companies' disclosure of climate risks and gaps in existing disclosure requirements. The task force also will analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies. This year, the SEC has released proposed rules specifically targeting the disclosure of climate-related and cybersecurity risks and has also issued comment letters to companies requesting clarification regarding their climate-related risk disclosures. The SEC's rulemaking agenda also includes additional human capital and board diversity disclosures that are slated to be released later this year or early next year, with a view to providing investors with greater insight into risks and performance in these areas. SEC Chair Gary Gensler has noted that the recent proposed rulemaking is in line with the "core bargain from the 1930s . . . that investors get to decide which risks to take, as long as public companies provide full and fair disclosure and are truthful in those disclosures." Regulators abroad are also taking similar action: the EU's Corporate Sustainability Reporting Directive will require companies operating in the EU (including certain subsidiaries of foreign companies) to identify and disclose how they are managing sustainability-related risks, while the UK's Financial Conduct Authority has passed measures requiring UK-listed companies to disclose in their annual financial reports climate-related risks aligned with the recommendations of the Task Force on Climate-related Financial Disclosures.

Notwithstanding the significant investor and regulatory pressure for corporate transparency on ESG and sustainability risks, there is also a growing wave of pushback from certain state legislatures and investors against efforts to disclose and mitigate ESG risks. In August, a coalition of 19 state attorneys general issued a letter to BlackRock admonishing it for its policies on climate change and ESG matters and alleging that its "past public commitments indicate that it has used citizens' assets to pressure companies to comply with international agreements such as the Paris Agreement that force the phase-out of fossil fuels, increase energy prices, drive inflation, and weaken the national security of the United States." State legislatures in Texas, West Virginia, Kentucky, Tennessee, Oklahoma and Florida have also adopted new prohibitions on investment funds that have ESG mandates. Texas has banned 10 large banks and 348 investment funds for allegedly boycotting fossil fuel-based energy companies critical to the state's economy while West Virginia has banned JPMorgan Chase, Wells Fargo, Goldman Sachs, Morgan Stanley and BlackRock from doing business with the state due to their decisions to cut back on financing to coal companies. It remains unclear whether such bans will steer institutional investors away from efforts to address climate and other ESG risks: a July study from the Wharton School indicates that the states may be paying the price for their policies with Texas paying between $303 million and $532 million more in interest on the $32 billion they borrowed during the first eight months after the anti-ESG laws Texas enacted in 2021 took effect and some large banks had to cease bond underwriting. Moreover, the institutions targeted by

these bans are frequently subject to other conflicting ESG-related laws, including foreign laws and to similar pressure from other stakeholders on these topics.

Recommendations for Improving ESG Risk Oversight

The board's function in overseeing management of ESG-related risks involves issue-specific application of the risk oversight practices discussed in this guide. The board should work with management to identify ESG issues that are pertinent to the business and its stakeholders and decide what policies and processes are appropriate for assessing, monitoring and managing ESG risks, as well as how to incentivize proper management of these risks. The board should also be comfortable with the company's approach to external reporting and shareholder engagement regarding the company's overall approach, response and progress on ESG issues. And it is increasingly important for directors and management who engage with shareholders to educate themselves and become conversant on the key ESG issues facing the company. Companies are also wise to assess whether there are ESG-related opportunities to be factored into business strategy.

Below are specific considerations that the board and appropriate board committees should consider as part of their oversight of ESG risks:

- understand the material ESG risks relating to their company along with the company's progress, targets, goals, initiatives and aspirations on ESG issues, recognizing that materiality as it applies to ESG continues to evolve;

- review the allocation of oversight responsibilities with respect to ESG matters on the board, including formalizing responsibilities among board committees and taking into account the respective capacities and existing functions of each board committee;

- integrate ESG considerations, where applicable, into discussions on business strategy, broader risk management processes and financial oversight;

- review and oversee the company's key ESG-related risk disclosures, including any ESG report and risk factor disclosures in the company's annual and quarterly reports filed with the SEC;

- review and assess management's monitoring and reporting processes with respect to ESG risks, including verification processes and internal controls, processes by which the board or board committee discuss ESG matters with management and the frequency of such discussions and whether there are ESG risk blind spots;

- periodically review the board's understanding of ESG issues, including whether the board would benefit from additional internal and external education and advisor assistance to ensure effective oversight; and

- ensure monitoring and oversight of ESG disclosures, strategies, policies, commitments and practices are properly documented in the board minutes and records.

VI. SPECIAL CONSIDERATIONS REGARDING CYBERSECURITY, RANSOMWARE, AND DATA PRIVACY RISKS

Cybersecurity increasingly has become a risk factor that requires special attention—both because it affects all aspects of most businesses and because failure to adequately identify, control and mitigate cyber risk can be devastating. The events of the recent years, which led the Biden administration to issue multiple Executive Orders declaring cyber threats a "top priority and essential to national and economic security," underscore this need. The risk of targeted attacks from criminal groups, foreign intelligence services and other bad actors has increased with the mass shift to remote work arrangements, embrace of cloud-based operations, increased reliance on virtual commerce spurred by the pandemic, and the proliferation of the Internet of Things. CEOs surveyed by PwC for its 25th Annual Global CEO Survey ranked cyber risks as the top threat to growth, as evidenced by (among many other examples) the attacks on the Colonial Pipeline and on SolarWinds. Geopolitical tensions have augmented cybersecurity risks—in March 2022, President Biden issued a public warning that Russia was considering conducting cyberattacks against U.S. entities and U.S. critical infrastructure, as part of Russia's response to Ukraine-related sanctions. This risk came to fruition in the January 2022 destructive malware operation targeting multiple organizations in Ukraine, and in a crippling cyberattack against Toyota following Japanese condemnation of Russia's invasion of Ukraine. Incidents such as these underscore the imperative that companies diligently consider cybersecurity risks, mitigate vulnerabilities, engage in active and multi-layered defense, leverage law enforcement resources and third-party specialists identified in advance, plan for a robust and rapid incident response and consider securing appropriate insurance coverage.

At the same time, legal and regulatory demands on companies to safeguard consumer data, protect against intrusions, and make related disclosures to government agencies, stockholders and the public have increased in recent years. The EU's General Data Protection Regulation ("GDPR"), which took effect in 2018, has transformed data handling obligations of companies whose operations have even a minimal European nexus, as has domestic legislation like the California Consumer Privacy Act ("CCPA") of 2020 and the Virginia Consumer Data Protection Act of 2021.

Federal and state agencies have made cybersecurity a focus, bringing attention-grabbing enforcement actions for failure to abide by their overlapping webs of requirements. In November 2020, a little over a year after its historic data privacy settlement with Facebook, the Federal Trade Commission ("FTC") announced a settlement with Zoom for alleged misrepresentations to consumers about encryption levels and vulnerability of its software to remote video surveillance. This settlement is just one illustration of the FTC's increased enforcement activity in the data privacy and protection arena—a trend likely to persist despite a recent Supreme Court decision cutting back the agency's ability to pursue disgorgement and restitution remedies. Another agency that has been particularly active of late is the New York State Department of Financial Services (NYDFS), which has brought actions enforcing the detailed and prescriptive cybersecurity regulations it put in place in 2019.

There is a silver lining to the twin pressures of increased cyber risk and accompanying regulatory focus: more sophisticated and nuanced guidance to companies about

cybersecurity risk oversight, management and disclosure. For example, the U.S. Department of the Treasury, Office of Foreign Assets Control ("OFAC") and Financial Crime Enforcement Network in October 2020 issued advisories to assist in combating ransomware attacks and to comply with sanctions and anti-money laundering regulations. In February 2021, NYDFS issued two guidance memos, one addressing cyber insurance, and another recommending steps that entities with public-facing websites should take to prevent unauthorized access to nonpublic information.

The SEC, for its part, has had cybersecurity interpretive guidance in place since 2011, requiring companies to "disclose the risk of cyber incidents if they are among the most significant factors that make an investment in the company speculative or risky." That guidance was clarified in 2018, and was supplemented in early 2020 by the Office of Compliance Inspections and Examinations' Cybersecurity and Resiliency Observations. But in recent proposed rulemakings, the SEC has taken an even more active role in cybersecurity. In February 2022, it proposed cybersecurity rules for registered investment advisers and funds, and for public companies, with complementary rules for registered broker-dealers and other market intermediaries forthcoming. The proposed rules for registered investment advisers and funds encompass cybersecurity risk management policies and procedures, enhanced disclosure of cybersecurity risks and incidents, and recordkeeping requirements. The proposed rules for public companies also address both cybersecurity incident disclosure and cybersecurity policies and procedures, but add requirements for disclosure of director and management expertise. While the rulemakings are not final, all affected organizations should assess their current cybersecurity-related policies and procedures to identify and address any notable gaps between existing approaches and SEC expectations.

The SEC has also taken enforcement action on the cybersecurity front, such as a 2021 settled administrative order with Pearson plc, finding violations of the negligence-based antifraud provisions of the Securities Act and imposing a civil penalty after the company failed to disclose a major breach and responded to press inquiries by downplaying the breach, and in 2021 announced settled charges against First American Title Insurance Company for failure to maintain disclosure controls and procedures sufficient to ensure that all available relevant information concerning a cybersecurity problem was analyzed for inclusion in the company's disclosures. These actions underscore that disclosure decisions concerning cybersecurity incidents must be grounded in a full understanding of all material facts. If a company chooses to make a public statement, it must be accurate and not misleadingly incomplete. Further, companies cannot limit risk-factor language to boilerplate if they have experienced a major undisclosed cyber breach involving significant exposure of sensitive data.

Given the uptick in recent years in ransomware attacks—installation of malware that encrypts business data in an effort to extort ransom, usually in the form of cryptocurrency—against companies across various industries (such as the Russian-originated NotPetya attack which caused some $1.4 billion in damage to a global pharmaceutical company), the White House, in June 2021, issued an open letter to the private sector encouraging corporate leaders to view the specter of a ransomware attack as a direct threat to core business operations. The letter recommended that executives immediately convene their leadership teams to ensure that cyber defenses, as well as incident response, continuity and recovery plans were tailored to the evolving risk landscape. Later the same month, NYDFS issued guidance describing a number of

ransomware prevention measures that NYDFS-regulated entities should integrate into existing cybersecurity programs. In 2020, OFAC promulgated guidance that ransomware payments may violate OFAC regulations.

Broadly speaking, the available regulatory and other guidance tracks the framework established by the National Institute of Standards and Technology ("NIST"), a critical benchmark that has been used and endorsed by the SEC and the FTC. The NIST elements are: identification of risk, protection of key data and systems, incident detection, incident response (including disclosure) and recovery. At the board level, the guidance is appropriately less operational and instead focused on ensuring that management is thinking about and addressing cyber risk in line with the company's risk profile and organizational goals and strategy. These principles are reflected, for example, in the April 2021 Board Cybersecurity Oversight Guidance issued by the World Economic Forum ("WEF"), the National Association of Corporate Directors and the Internet Security Alliance, in partnership with PwC, and in the WEF's May 2021 white paper titled "Cyber Resilience in the Oil and Gas Industry: Playbook for Boards and Corporate Officers."

In general, the applicable guidance and our experience inform the following takeaways with respect to cyber risk:

- Oversight Mechanism: Boards should carefully consider with management the avenues through which they monitor cyber risk. Although it is common to delegate cyber risk oversight to the audit committee, this should be carefully considered given the burden on audit committees. An alternative is the formation of a dedicated, cyber-specific board-level committee or sub-committee. At the same time, because cybersecurity considerations increasingly affect all operational decisions, they should be a recurring agenda item for full board meetings. Companies that already have standalone risk or technology committees should also consider where and how to situate cybersecurity oversight. The appointment of directors with technology experience should be evaluated alongside director education.

- Review of Policies, Procedures & Resources: In carrying out their oversight function, directors should ensure that the company has written policies and procedures in place governing each of the NIST elements, and that both the cybersecurity and the internal audit functions include technical expertise and sufficient time and resources to devote to cybersecurity risk and review. A review of the common elements of remedial and other cyber-related enforcement actions suggests a growing expectation among regulators that companies maintain written information security programs that senior management present to the board at least annually.

- Verification of Risk Identification & Assessment: Directors should have a working understanding of the company's systems, and the data it collects, as well as the risks posed by how the company uses technology and collects and stores data. While managing the cybersecurity-related risks of remote work is a task that virtually every company has taken on as a result of the pandemic, each company's cyber risk profile is unique. The role of directors is to ensure that an effective cyber risk assessment and mitigation system is in place, that those managing the company's cybersecurity

identify and consider potential vulnerabilities (leveraging the latest threat intelligence and best practices) and that the board is engaged in active oversight of such matters.

- Oversight of Protection & Detection Strategies: Directors should be briefed on management's plan for protecting against cyber intrusions and related risks, including programmatic efforts to detect and mitigate vulnerabilities and enable business continuity. In addition, directors and executives should maintain a sustained focus on the timely remediation of material cyber risks, whether identified by internal or external sources, and, where appropriate protective or remedial recommendations are promptly implemented in response to identified exposures. Responsible personnel should engage in continuous monitoring and improvement efforts, including as to prosaic but mission-critical tasks like timely patching of critical systems, prompt installation of third-party software updates, and attentiveness to relevant industry bulletins (such as those released by the U.S. Cybersecurity & Infrastructure Security Agency). Knowledgeable employees from the internal audit function should usually be involved as well.

- Oversight of Response Strategy and Disclosure Protocols: Directors should receive briefings from time to time on management's protocols for a swift, robust and effective response to a breach or other cybersecurity incident, as well as on the company's response to material cybersecurity incidents and related impacts. A company's response plan should cover all likely incident scenarios, as well as plausible scenarios with extreme consequences. The plan should address notification and response protocols, procedures for escalation to appropriate management personnel and ultimately the board, business and service interruption scenarios (including whether systems could or should be taken offline as a precautionary measure) and communications with regulators and stakeholders. The company should also have a coherent and legally vetted plan for making appropriate and compliant disclosures and notifications to law enforcement, industry-specific regulators, consumers, and the public if and when data or other systems are materially compromised. Occasional "fire drills" should be considered.

- Documentation of Board-Level Oversight: Finally, board and committee oversight activities, including in the aftermath of a material cyber incident that causes significant harm or disruption, should be appropriately documented in minutes and in supporting materials. Shareholder books and records inspection demands in preparation for litigation are increasingly common and allowed by the courts where certain pleading requirements are met.

VII. CONCLUSION

Anticipating Future Risks

Understanding risks inherent in the company's strategic plans, risks arising from the competitive landscape and potential for technology and other developments to impact the company's profitability and prospects for sustainable, long-term value creation is critical to effective board-level risk oversight. Gaining that understanding, of course, will allow boards and

management to anticipate future risks, which, in turn, is critical to avoiding or mitigating those risks before they escalate into crises.

As stressed in the NACD's report, "Fit for the Future," boards are entering a time of both extreme challenge and promise:

> *The accelerating pace and intensifying complexity of change are leading to the emergence of a fundamentally different operating reality than incumbent executives and directors have experienced in their careers to date. However, this dizzying amount of change also creates immense opportunities for companies to out-innovate the competition, to generate value in new ways, and to strengthen their governance.*

The Road Ahead

Directors face a rapidly evolving risk and governance landscape, and boards are now recognized as having responsibility, as part of their oversight function, to use their business judgment working with management to assist in identifying material business and liability risks and to help articulate the strategy and the time horizon for mitigating these risks. Such expectations for board oversight have been reinforced by recent Delaware decisions that have turned on whether a company can point to documented processes for overseeing and responding to significant enterprise risks. In the wake of the pandemic and growing macroeconomic uncertainty and geopolitical instability, investors are increasingly looking to the board to take the lead on identifying, monitoring and mitigating risks, including taking steps to work with management and advisors to adapt risk management processes to evolve with the changing risk landscape and stakeholder expectations. Boards that take steps to implement and adhere to fit-for-purpose risk oversight processes will help play a critical role in protecting corporate reputation, engendering trust among shareholders, regulators and other stakeholders and ensuring long-term corporate health.

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September 16, 2022

SEC's Regulation FD Litigation Highlights Potential Perils When Speaking with Analysts

Regulation FD prohibits public companies and their personnel from selectively disclosing material nonpublic information to various categories of people, including securities analysts. The SEC's enforcement staff vigorously pursues violations of Regulation FD, although litigated cases are rare. One such case is currently pending, as we described last year. The court recently denied motions for summary judgment by both the SEC and the defendants. *SEC* v. *AT&T, Inc., et al.*, 21 Civ. 1951 (PAE) (S.D.N.Y. Sept. 8, 2022). Judge Engelmayer's comprehensive opinion is a textbook treatment of issues that commonly arise in investigations concerning Regulation FD. Absent a settlement, the case will now move ahead to trial.

The SEC's charges center on the activities of three investor relations personnel, all of whom are defendants in the case. The SEC alleges that the three defendants conducted a lengthy series of individual conversations with securities analysts in March and April of 2016, for the purpose of "walking down" consensus estimates for AT&T's Q1 performance, in which they communicated nonpublic information about specific financial and operational metrics.

As is common in Regulation FD cases, the SEC assembled voluminous evidence concerning what the IR personnel said in their conversations with analysts, including contemporaneous notes taken by the analysts, internal communications by the analysts with their colleagues following the conversations, testimony of the analysts, and the record of changes made by analysts to their financial models in the wake of the conversations. Although the defendants denied that they communicated certain information to analysts, the court found those assertions lacked credibility in view of the extensive contemporaneous evidence. The court concluded that the evidence is "overwhelming" that the defendants selectively communicated information that was both material and nonpublic.

By contrast, the court ruled that, based on the evidence, a jury could conclude either way on the element of intent. Evidence that could support the necessary finding of recklessness includes the "sheer number" of disclosures of confidential information as part of a "systematic campaign" over a six-week period until analysts' Q1 performance expectations had moved down to the desired levels, the "numerous violations" of company policy regarding Regulation FD, and the

"extensive and explicit training" that the defendants received as to Regulation FD. At the same time, the court found that a jury could conclude that the defendants lacked the necessary intent if it credited the defendants' assertions that they did not understand that the information they were communicating was material and nonpublic, or based on the absence of any evidence that anyone at the company (or any of the analysts) expressed any concern about the legality of the communications at the time they were occurring.

The court also addressed additional issues that commonly arise under Regulation FD. The defense argued that the information conveyed in the analyst calls was neither material nor nonpublic because it was previously disclosed. The court found, however, that the prior statements about trends in the business were "at a high level of generality," as distinct from the specific metrics disclosed in the analyst calls. In addition, there was evidence that in some conversations, analysts were told that certain metrics were "consensus" (i.e., publicly available) numbers. The court found that these characterizations were not accurate – that the defendants disclosed the company's internal projections at a time when the publicly tabulated consensus numbers were different.

The court's opinion is noteworthy as it is unusual to see Regulation FD issues adjudicated on a full factual record. Above all else, the case dramatically illustrates the potential pitfalls when IR personnel speak with analysts, particularly if they do so with the aim of altering consensus expectations. The court's findings provide a telling reminder that care must always be taken when planning such calls to ensure that material nonpublic information is not selectively shared and that a contemporaneous record of the substance of communications with analysts be kept to confirm Reg FD compliance. The case also reflects a number of important practical realities: the SEC will always be suspicious of intentional efforts to "walk down" Wall Street analysts; great care is needed whenever IR personnel discuss trends and outlooks with analysts; training and oversight in this area is crucial and should be periodically refreshed; it is permissible under Regulation FD to direct analysts to information that is genuinely publicly available in order to encourage them to revisit their estimates; and seeking legal advice concerning compliance with Reg FD is essential before addressing a perceived disconnect between a company's internal estimates and analysts' consensus views.

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September 16, 2022

ESG, Stakeholder Governance, and the Duty of the Corporation

Recently, there has been much confusion and misinformation about (1) environmental, social, and governance (ESG) considerations, (2) the ways in which companies, boards, asset managers, investment funds, and other market participants can, do, and should factor such considerations into their decision-making processes, and (3) the need for companies to consider, balance, advance, and appropriately protect stakeholder interests in order to create value, generate sustainable returns, and guard against downside risks to value and corporate health. This cloud of confusion stems, in part, from nascent efforts to politicize ESG. Consider the Trump administration's proposed rulemaking in the Department of Labor that would have required fiduciaries of retirement plans making investment decisions to focus solely on "pecuniary" factors (and, in turn, would have burdened the ability of fiduciaries to appropriately take ESG factors into account in selecting investments and engaging in risk-return analyses). And consider the letter sent to BlackRock last month by 19 Republican attorneys general, accusing the asset manager of prioritizing its "climate agenda" over the interests of pensioners' investments. These developments unfortunately fail to appreciate that ESG, properly understood, is merely a collection of quite disparate risks that corporations face, from climate change to human capital to diversity to relations among the board, management, shareholders, and other stakeholders. We write to resituate the role of ESG and stakeholder governance within the well-established legal framework of corporate fiduciary duties.

Dating back to the 1932 law review exchange between Merrick Dodd and Adolf Berle, there has been a long-running debate over whether the purpose of the corporation is to maximize short-term profits for shareholders or, instead, to operate in the interest of all of its various stakeholders to promote the long-term value of the corporation. For several decades, the predominant view among corporate leaders, practitioners, academics, investors, and asset managers was that the role of the corporation was solely to maximize profits for shareholders. This theory, which came to be known as shareholder primacy, is epitomized by Milton Friedman's seminal 1970 essay, The Social Responsibility Of Business Is to Increase Its Profits, in which he argued that every corporation should seek solely to "increase its profits within the rules of the game." Friedman's shareholder-centric view of corporate purpose posited that a corporation that "takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers" would undermine "the basis of a free society."

We long have advocated for a broader view of corporate purpose than that espoused by Friedman — initially, as we wrote in 1979 in Takeover Bids in the Target's Boardroom, to empower boards to take into account the interests of all stakeholders, including the communities in which corporations operate, in repudiating takeover bids by opportunistic raiders; and later, to ensure that directors are encouraged to resist short-termist pressures and can exercise their business judgment to consider the variety of stakeholder interests essential to promoting sustainable success and growth in long-term corporate value. The 2008 financial crisis laid bare the dangers of the Friedman doctrine and marked the decline of shareholder primacy, exposing the reality that an exclusive focus on short-term maximization of shareholder value came at the expense of sustainable growth and innovation. Business leaders, policymakers, and investors have since increasingly

advocated for a broader view of corporate purpose, one that promotes the long-term value of the corporation.

The growing acceptance of stakeholder corporate governance is captured by, among other developments, the World Economic Forum's publication of The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth; the Davos Manifesto 2020 (see our prior memo here); and the Business Roundtable's 2019 rejection of the shareholder-centric view to which it had held firm over the prior two decades (see our prior memo here). Stakeholder corporate governance's acceptance is also seen in the many actions and investments by corporations intended to benefit stakeholders, including investors and non-investor constituencies, and to reduce negative externalities.

The term "ESG" was popularized in the early 2000s following the publication of the UN Global Compact's report, Who Cares Wins. Today, the concept of ESG is multifaceted: companies and boards take into account ESG and stakeholder considerations when developing and delivering products and services, making business decisions, managing risk, developing long-term strategy, recruiting and retaining talent and investing in the workforce, implementing compliance programs, and crafting public disclosures. Many major asset managers, including BlackRock, State Street, and Vanguard as well as actively managed funds, consider ESG issues in formulating investment strategies, serving their clients, and exercising their fiduciary responsibilities. This encompasses investors being able to exercise their professional judgment in considering ESG-related information when evaluating the risk *and* return profile of portfolio holdings. Certain ESG investment funds may also invest exclusively in companies that satisfy predetermined ESG standards. And regulators and enforcement authorities develop principles to promote consistency and reliability across ESG disclosures, and scrutinize such disclosures in companies' public filings.

The phenomenon of ESG is prevalent not only in the United States but around the world, as companies, policymakers, global leaders, academics, and investors debate how best to promote sustainability over the long term. ESG, properly understood, is not a unitary principle or even a collection of a fixed set of particular principles. Rather, ESG encapsulates the range of risks that all corporations must carefully balance, taking into account their specific circumstances, in seeking to achieve long-term, sustainable value. It is thus no surprise that asset managers and asset owners, too, are expecting well-run companies to incorporate ESG matters into their business decisions appropriately. Although the ESG moniker is relatively recent, corporate boards and management have long considered ESG factors and risks in setting and executing strategy. As Jeffrey Sonnenfeld recently pointed out, doing so is associated with superior financial results, and consistent with long-accepted norms as to the place of business in society.

To be sure, not all market participants embrace ESG principles. Recently, an anti-ESG movement has emerged, one opposed to consideration of ESG factors in investment decision-making in favor of a Friedmanist exclusive focus on shareholder primacy. This false dichotomy between ESG and shareholder value mirrors the confusion sewn by critics of stakeholder governance who pit shareholders against other stakeholders through the misleading allure of an existential conflict that requires directors to choose between value for one versus the other. But as we have previously explained here and here, the law of corporate fiduciary duties nowhere demands

that choice — and opponents of stakeholder governance know it, as do critics of ESG. The purpose of a corporation is to conduct a lawful, ethical, profitable, and sustainable business in order to ensure the success and grow the value of the corporation over the long term. This requires consideration of all of the stakeholders critical to the success of the business (shareholders, employees, customers, suppliers, and communities), as determined by directors based on their business judgment and informed by regular engagement with shareholders. Such consideration includes ensuring that a company avoids ESG blindspots.

The first principle of corporate law is that a corporation must conduct lawful business by lawful means. To honor this axiom, the *Caremark* doctrine requires that companies have in place information and reporting systems reasonably designed to provide timely, accurate information to allow management and the board to reach informed judgments about the corporation's compliance with law and its business performance. The stakeholder governance model aligns closely with *Caremark* — for example, environmental risks have long been a core focus of compliance programs, and to the extent a company adequately addresses these risks through comprehensive compliance programs and operational adjustments, it will be well-positioned to meet the demands of the environmental component of ESG. As we recently wrote, it is important for companies to have high-quality risk management policies and processes, and for boards to oversee the monitoring and management of risk, to protect the long-term value of the company, and to fulfill *Caremark* duties. Risk management policies and oversight must reach ESG and sustainability-related risks that can damage and disrupt a company's strategies, business positioning, operations, and relations with stakeholders, including over the long term.

A holistic, stakeholder view of corporate purpose does not exalt ESG as the sole or weightiest consideration — to the contrary, it recognizes that the various elements of ESG are among numerous considerations that are essential to a company's sustainability and that must be carefully balanced by the board and management, in consultation with shareholders, to ensure the long-term health and prosperity of the business. One example, highlighted by BlackRock in its written response to the attorneys general, is the long-term risk to companies posed by climate change and the economic opportunities from the energy transition. By engaging with shareholders and thought leaders on these complex topics, management teams and boards can arm themselves with the knowledge necessary to understand the relevant risks and to develop strategies to support sustainable growth.

The unfortunate confusion that has entered the contemporary debate regarding ESG misunderstands the fundamental purpose of the corporation. We continue to believe it is essential that boards operate under a governance model that permits consideration of ESG principles and sustainable investment strategies, with the support of investors and asset managers, to promote long-term corporate value and to fortify the enterprise against relevant risks. There should be no doubt that the law in Delaware and in every other U.S. jurisdiction empowers boards to follow this course for responsible corporate stewardship and corporate success.

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September 1, 2022

Dealing with Activist Hedge Funds and Other Activist Investors

Introduction

The SEC rule requiring a universal proxy card in director election proxy fights becomes effective today. The resurgence of activism is already in progress, and the universal proxy card may significantly facilitate some proxy contests in which an activist is seeking to elect one or more directors to a company's board to replace incumbent(s). It will also affect proxy contest strategies, tactical considerations and the behavior of proxy advisory firms assessing competing director slates. As stated by ISS in its report on the universal proxy card:

> The indisputable fact about the universal proxy card (UPC) is that it is a far superior way for shareholders to exercise their voting franchise than the two-card system that has dominated proxy contests for decades. But like the kid that receives the hot new toy at Christmas, only to become frustrated by its complex instructions, proxy advisors and investors will have to carefully navigate the first few UPC contests. Although UPC contests will increase the workflow of institutional investors, many funds have ramped up teams to evaluate these situations in recent years, so they are likely well prepared for this shift.

As we have previously noted, regardless of industry, size, performance or "newness" to the public markets, no company should consider itself immune from activism. No company is too large, too new or too successful. Even companies that are respected industry leaders and have outperformed the market and their peers have been, and are being, attacked. And companies that have faced one activist may be approached, in the same year or in subsequent years, by other activists or re-visited by the prior activist. The past two years of substantial economic, societal and market shifts have created new vulnerabilities and opportunities for activists and for companies.

Although asset managers and institutional investors will often act independently of activists, the relationship between activists and asset managers and investors in recent years has encouraged frequent and aggressive activist attacks. A number of hedge funds have also sought to export American-style activism abroad, with companies throughout the world now facing classic activist attacks. In addition, the line between hedge fund activism and private equity continues to blur, with some

activist funds becoming bidders themselves for all or part of a company, and a handful of private equity funds exploring activist-style investments in, and engagement with, public companies.

Traditional activism, focused on short-term profit, stock price and total shareholder return (TSR), continues alongside a new form of activism emphasizing climate and other environmental, employee/human capital, social and governance (ESG) considerations. The activism landscape has also evolved to include dual purpose activists who combine both TSR and ESG arguments, as well as "pincer attacks" from ESG and TSR activists acting independently or in concert against the same company.

The outcomes of recent economic and ESG-related proxy fights, activism campaigns and non-public activist approaches across industry sectors underscore the importance of advance preparedness to anticipate, prevent and respond to an activist attack. This includes not only the more traditional governance and economic components of activist campaigns, but also the ESG themes that some activists have been deploying in their attacks (including and subsequent to the Exxon proxy fight successfully waged by ESG activist Engine No. 1 last year). The new universal proxy card rule only increases the importance of being prepared.

For many years, we have been updating this memo based on recent developments, evolving trends and our experiences avoiding, defusing, resolving and prevailing in contested situations and proxy fights to provide the most cogent and current advice to our clients and friends. Summarized below is a snapshot of some of the tactics and themes deployed by activists, followed by a checklist of matters to be considered in putting a company in the best possible position to prevent, respond to or resolve an activist attack.

The Attack Devices Used by Activists

- Seeking to force a sale of the company by leaking or initiating rumors of an unsolicited takeover approach, publicly calling for a sale, acting as an (unauthorized) intermediary with strategic acquirers and private equity funds, taking positions in both the target and the acquirer, making a "stalking-horse" bid for the company (with or without secured financing), partnering with a hostile acquirer to build substantial stock positions in the target to facilitate a takeover, or partnering with private equity funds.
- Aggressively criticizing a company's governance, management, business and strategy, sustainability and ESG strategies, and presenting the activist's own recommendations and business and ESG plans, through a "white paper" or other public documents or statements.

- Proposing a precatory proxy resolution for actions prescribed by the activist or the creation of a special committee of independent directors to undertake a strategic review to "maximize shareholder value" and/or meet ESG goals, especially with respect to environmental impact.
- Demanding an accelerated "Investor Day" at which the company would be pushed to disclose aggressive forward-looking projections, financial targets and actions involving the portfolio and allocation of capital.
- Recruiting candidates with industry experience (including retired CEOs of major companies or even former executives of the target) to serve on dissident slates, and conducting (or threatening to conduct) a proxy fight to get board representation at an annual or special meeting or through action by written consent.
- Orchestrating a "withhold the vote" campaign against the company's incumbent directors.
- Leveraging the proxy advisory firms and their recommendations to amplify the activist's influence.
- Communicating with and rallying institutional investors and sell-side research analysts to support the activist's arguments.
- Using stock loans, options, derivatives and other devices to accumulate positions secretly, announce surprisingly large, leveraged economic stakes or increase voting power beyond the activist's economic equity investment.
- Pairing economic arguments with governance or ESG proposals, in an effort to garner support from proxy advisory and governance teams within institutional investors.
- Using sophisticated public relations, social media and traditional media campaigns to advance the activist's arguments.
- Investing in significant diligence and third-party consulting services to analyze the target's strategy, business, operating margins and/or ESG impact.
- Seeking to create divisions within the boardroom or between the board and management; several major activists have been successful in achieving such wedges.
- Reaching a company's retail shareholders through Internet forums and social media channels, weekly mailings, telephonic outreach, local newspaper advertisements and user-friendly infographics.

- Hiring private investigators to create dossiers on directors, management and key employees and otherwise conducting aggressive "diligence."
- Initiating or threatening litigation, including demands for books and records, sometimes concurrently with a proxy fight.
- Waging repeated campaigns at the same company, regardless of the outcome of the initial campaign, or joining with other activists to converge on the same company at the same time.

Current SEC rules do not prevent an activist from secretly accumulating a more than 5% position before being required to make public disclosure and do not prevent activists and institutional investors from privately communicating and cooperating. We have long sought to correct this loophole, and potential reforms are under consideration.

Prevention of, or response to, an activist attack is an art, not a science. There is no substitute for preparation. The issues, tactics, team and approaches to an activist challenge will vary depending on the company, the industry, the activist and the substantive business and governance issues in play. To forestall an attack, a company should regularly review its business strategy and portfolio, how it is balancing growth and profitability, margin priorities and pressures, its ESG issues and strategy, and its governance and executive compensation. In addition to a program of advance engagement with investors, it is essential to be able to mount a defense quickly and to be agile in responding to changing tactics. A well-managed corporation executing clearly articulated, credible strategies can prevail against an activist by making its case to the rest of its shareholders. A well-advised corporation should also play offense in anticipation of activism and in resolving activism.

Many investors increasingly expect companies to at least seek to engage constructively with activists. Given the risks and potential harm of a full-blown battle, in certain situations the best response to an activist approach may be to seek to negotiate with the activist and reach a settlement on acceptable terms, if such a settlement is feasible, even if the company believes it could win a proxy fight. However, when a negotiated resolution is not achievable on acceptable terms, whether because the activist's proposals are inimical to the company's business goals and strategy or because the activist is unwilling to be reasonable in its negotiation, the ability to wage an effective campaign in response to the activist will depend on advance preparation, strong alignment between the board and management, proactive action, good judgment and effective relationships with shareholders.

Advance Preparation

Create Team to Deal with Activism:

- A small group of key officers plus legal counsel, investment banker, proxy soliciting firm and public relations firm.
- Continuing contact and periodic meetings or calls with the team are important.
- A periodic fire drill with the team is helpful to maintain a state of preparedness; the team should be familiar with the hedge funds and other investors that have made activist approaches generally and be particularly focused on those that have approached other companies in the same industry and the tactics each fund has used; the team should also use that familiarity to be alert to any contacts or interest shown by known activists.
- Periodic updates to the company's board of directors.
- Regular review by counsel expert in activism and takeover defense of the company's structural "defense" profile, including as reflected in its charter, bylaws and other governing documents and policies, with an eye towards ensuring effective practices and avoiding reflexively capitulating to "one size fits all" approaches that may prove unduly empowering of hostile actors, involve premature changes in light of company-specific circumstances or otherwise not be in the best interests of the company.

Shareholder Relations:

- The investor relations officer is critical in assessing exposure to an activist attack and in a proxy solicitation. In many companies, the CFO is also critical to the investor relationships, and the chief legal officer/general counsel or her/his designee may have crucial relationships and be one of the officers that spend time with the major index funds and the stewardship/proxy voting teams at the actively managed funds. The credibility that these officers have with the institutional shareholders has been determinative in a number of proxy solicitations. Candid assessment of shareholder sentiment should be appropriately communicated to senior management, with periodic briefings provided to the board.
- Articulate, update and share the company's position on corporate purpose, employee priorities, material social issues, diversity, ESG and long-term sustainability in appropriate forums.
- Review broader capital allocation framework (including reinvestment in the business and inorganic as well as organic growth strategies), capital return policy (dividends and buybacks), analyst and investor presentations and other

financial public relations matters (including disclosed metrics, key performance indicators (KPIs) and guidance).

- Monitor peer group, sell-side analysts, proxy advisors, active asset managers, and internet commentary and media reports for opinions or facts that will attract the attention of activists. These sources may also provide advance warning of themes that an activist may be promoting or testing.
- Articulate and consistently maintain the company's basic strategic message while updating the strategy as circumstances warrant.
- Objectively assess input from shareholders and whether the company is receiving candid feedback. The company should make sure that major investors feel comfortable expressing their views to the company and believe that the company honestly wants to hear any concerns or thoughts they have.
- Proactively address reasons for any shortfall versus peer benchmarks, including reasons why peer comparisons may be inapposite. Be aware of ESG shortfalls against perceived corporate leaders even if they are not in the same industry. Anticipate key questions and challenges from analysts and activists, and be prepared with answers. Monitor peer activity and the changes peers are making to their businesses, as well as key industry trends.
- Build credibility with shareholders and analysts before activists surface.
- Monitor changes in hedge fund and institutional investor holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders. Pay close attention to activist funds that commonly act together or with an institutional investor. Pay close attention to investors who are known to enlist activist funds or deploy activist campaign tactics.
- Maintain regular contact with major institutional investors, including both portfolio managers and proxy voting/governance departments; CEO, CFO and independent director participation is very important, and the role of the CLO/GC should also be considered, especially with the index funds and stewardship teams. Consider engagement with proxy advisory firms.
- Major institutional investors, including BlackRock, Capital Group, Fidelity, Invesco, State Street, TIAA, T. Rowe Price, Vanguard and Wellington, have established significant proxy departments that make decisions independent of ISS, and the portfolio managers at actively managed funds covering the company often have clear "override" authority on key votes. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision-makers and point persons are and how best to reach them.

It may be possible to defeat an activist attack supported by ISS by gaining the support of major institutional shareholders.

- Consider whether enhancements to company disclosures or updates to governance and oversight practices are appropriate in light of evolving shareholder expectations, including with respect to ESG.
- Monitor third-party governance and ESG ratings and reports and seek to correct inaccuracies.
- Monitor annual meeting vote results and develop plans for dealing with problematic vote outcomes through shareholder engagement, while taking a measured approach that prioritizes the best interests of the company and does not over-react or "over-index" on voting percentages.
- Maintain up-to-date plans for contacts with media, regulatory agencies, political bodies, industry leaders and other stakeholders, and refresh relationships.
- Monitor investor conference call participants, one-on-one requests and transcript downloads.
- Deal with shareholder proposals (such as those submitted under Rule 14a-8) effectively, recognizing that engagement and negotiated withdrawals of such proposals and creative approaches to the board's recommendation and proxy statement regarding such matters may be superior to classic "always oppose" or "always seek to exclude" approaches.

<u>Prepare the Board of Directors to Deal with an Activist Situation</u>:

- Maintaining a unified board consensus on key strategic issues is essential to success in the face of an activist attack; in large measure, an attack by an activist hedge fund is an attempt to drive a wedge between the board and management by raising doubts about strategy and management performance and to create divisions on the board, which may include advocating that an unnecessary special committee be formed.
- Keep the board informed of options and alternatives analyzed by management, and review with the board basic strategy, capital allocation, the portfolio of businesses, margins and corporate ESG strategies in light of possible arguments for spinoffs, share buybacks, increased leverage, special dividends, cost-cutting initiatives, a sale of the company or other structural or business changes or ESG reforms.

- Schedule periodic presentations by legal counsel and the investment banker to familiarize directors with the current activist environment and the company's preparation.
- Directors should guard against subversion of the responsibilities of the full board by the activists or related parties, and directors should be instructed to avoid being drawn into conversations with third parties and to refer all approaches by activists to the CEO.
- Boardroom debates over business strategy, direction and other matters should be open and vigorous but stay confidential and be kept within the boardroom.
- Recognize that psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a target.
- Scrutiny of board composition is increasing, and boards should self-assess regularly. The benefits of tenure and experience became apparent through the Covid-19 pandemic and other economic, geopolitical and supply chain shocks to industry, but in a contested proxy solicitation, institutional investors may particularly question the "independence" of directors who are older than 75 or who have lengthy tenures, especially where the board has not recently appointed new directors, in addition to more broadly assessing director diversity, expertise and attributes. Directors may also be criticized for "overboarding" or attendance issues. Meaningful director evaluation is now a key objective of institutional investors, and a corporation is well advised to undertake it and talk to investors about it. Regular board renewal and refreshment, and having longer-term board development and succession plans, can be important evidence of meaningful evaluation.
- A company should not wait until it is involved in a contested proxy solicitation to offer its key institutional shareholders the opportunity to meet with its independent directors. Many major institutional investors have recommended that companies offer scheduled meetings involving a company's independent directors. A disciplined, thoughtful program for periodic meetings and other engagement initiatives is advisable.

<u>Monitor Trading, Volume and Other Indicia of Activity</u>:

- Employ sophisticated stock watch service and monitor Schedule 13F filings.
- Monitor Schedule 13D and Schedule 13G and Hart-Scott-Rodino Act filings.
- Monitor parallel trading and group activity (the activist "wolf pack").
- Monitor activity in options, derivatives, corporate debt and other non-equity securities.

- Monitor attendance at analyst conferences, requests for one-on-one sessions and other contacts from known activists.

Responding to an Activist Approach

Response to Non-Public Communication:

- Assemble team quickly and determine initial strategy. Response is an art, not a science.
- No duty to respond, but failure to respond may have negative consequences, and in most cases response is desirable.
- No duty to discuss or negotiate, but usually advisable to meet with the activist and discuss the activist's criticisms and proposals (company participants in any such meeting should prepare carefully with the company's activist response team and there should be at least two company participants in any such meeting); no outright rejection absent study; try to learn as much as possible by listening; keep in mind that it may be desirable at some point to negotiate with the activist and that developing a framework for private communication may avoid escalation.
- Generally no immediate duty to disclose; determine when disclosure may be required or desirable.
- Response to any particular approach should be specially structured; team should confer to decide proper response. Consider whether some of the activist's claims, proposals or demands are consistent with the company's own pending or proposed initiatives or otherwise have merit.
- Keep board advised; in some cases, it may be advisable to arrange for the activist to present its white paper to the board or a committee or subset of the directors.
- Be prepared for public disclosure by the activist and have immediate public response contingencies ready in the event of any disclosure.
- Be prepared for the activist to try to contact directors, shareholders, sell-side analysts, business partners, employees and key corporate constituencies. Make sure directors understand that any contacts should be referred to the CEO or other designated officer.
- Assess whether there are sensible disclosures, commitments or business actions that can be made, taken or accelerated to preempt or undercut the activist attack and the extent to which the activist may attempt to publicly claim credit for such disclosures, commitments or actions.

- Consider whether negotiations with the activist and settlement should be pursued or explored and, if so, at what point in time.

Response to Public Communication:

- Initially, no response other than "the board will consider and welcomes input from its shareholders."
- Assemble team quickly; inform directors.
- Call special board meeting for the board to meet with the team and consider the communication.
- Determine board's response and whether to meet with the activist. Even in public situations, consider pursuing disciplined engagement with the activist. Failure to meet may also be viewed negatively by institutional investors. Recognize that the activist may mischaracterize what occurs in meetings. There should be at least two company representatives at any meeting or call with the activist.
- If the activist makes a demand – *e.g.*, replace the Chair or CEO – that the board finds unacceptable or non-negotiable, it may be advisable to make the board's position on that item clear earlier rather than later, even if there is willingness to consider and negotiate other aspects of the activist's platform.
- Avoid mixed messages and preserve the credibility of the board and management.
- Continuously gauge whether the best outcome is to agree upon board change and/or strategic, business or other action in order to avoid (or resolve) a proxy fight.
- Be prepared and willing to defend vigorously, if a reasonable settlement is not possible.
- Recognize that a proxy fight will entail a meaningful time commitment from both management and directors, and work in advance to coordinate availability for key meetings with shareholders and proxy advisory firms.
- Engage with other shareholders, not only the activist, to take investor temperature, solicit feedback and assess whether actions may (and should) be taken by the company to secure support (if an activist identifies a legitimate issue, the company may propose its own plan for resolving any shortcomings that is distinct from the activist's solutions or co-opts any sensible concepts).
- Appreciate that the public dialogue is often asymmetrical; activists may make personal attacks and use aggressive language or advance unrealistic financial

projections, but the company's response should be disciplined and fact-based and should not respond to personal attacks in kind.

- Remain focused on the business; activist approaches can be very distracting, but strong business performance, though not an absolute defense, is one of the best defenses. Similarly, unexpected poor performance can undermine a company's defense. When and if business challenges arise, act in a manner that preserves and builds credibility with shareholders.
- Maintain the confidence and morale of employees, partners and other stakeholders.
- A significant number of major institutional investors are increasingly skeptical of activists and activist platforms even as they closely scrutinize targeted companies as well. Investors can be persuaded not to follow the recommendations of ISS in support of a dissident's proxy solicitation. When presented with a well-articulated and compelling corporate purpose and plan for the long-term, sustainable success of a company, investors are able to cut through the cacophony of short-sighted gains promised by activists touting short-term strategies and advancing disingenuous attacks. As a result, when a company's management and directors work together to present a compelling long-term strategy for value creation, investors will listen.

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