Board Considerations for an Uncertain 2021

In her regular column on corporate governance issues, Holly Gregory explores the issues that boards will face in 2021 given the current economic uncertainty, social unrest, and 2019 novel coronavirus disease (COVID-19) pandemic.

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Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory, and listing rule requirements, and governance best practice.

In the current "black swan" era of heightened economic turmoil, social unrest, and the COVID-19 pandemic, boards of public companies have had to explore a range of issues in response to rapidly emerging risks. Interrelated trends have emerged, including:

- Renewed interest in the company's purpose in society, including its role in providing the goods and services that meet basic needs, as well as in innovation.
- Shifting emphasis from shareholder primacy to the interests of a broader set of stakeholders.
- Accelerating interest in environmental, social, and governance (ESG) matters, particularly the company's role in addressing social issues, including issues of racial and gender equality and social justice.

- Enhanced focus on the value of human capital and related changes in the nature of work and the workplace.
- The potential for significant reconfiguration of industries and business models, which raises concerns about business continuity.

These trends will shape the board's focus and priorities in 2021. While the specific priorities and their order will vary from board to board based on the unique circumstances facing the company, the key focus areas are likely to include:

- Corporate purpose and the "S" in ESG.
- Human capital, workforce, and culture issues.
- Strategic planning for long-term sustainable value.
- Management delegation, performance, succession, and compensation.
- Shareholder engagement and activism.
- Risk management, crisis preparedness, and compliance.
- Board composition and succession planning.

The majority of the board's time should be reserved for discussing corporate strategy and assessing the quality of management's performance, including management's focus on business continuity, opportunities, and risks.

CORPORATE PURPOSE AND THE "S" IN ESG

The COVID-19 pandemic and heightened concerns about racial inequality and social injustice have brought into sharper focus the shared interests of key stakeholders and companies in the health, economic well-being, and equitable treatment of society's members. For companies, engaging on these shared interests is not only a matter of being a responsible corporate citizen, but also a business imperative to satisfy investor, consumer, and employee expectations. It impacts the goodwill value of a company's reputation. All business continuity efforts in response to the COVID-19 pandemic, including issues of workforce continuity, supply chain continuity, demand implications, and liquidity concerns, are intertwined with issues of corporate purpose, stakeholder interests, corporate social responsibility, and corporate reputation.

Many stakeholders are looking to companies for assistance in finding solutions to the issues arising during the COVID-19 pandemic and in offsetting further damage, highlighting the social aspect of ESG. Boards and corporate leaders have a unique opportunity to clarify the value their companies provide to society, for example, through their provision of core goods and services, innovation, employment and training, and role in the supply chain.

Linking these efforts and the company's unique corporate purpose and business strategy will help to ensure alignment with the best interests of the company, and enhancement of long-term shareholder value. It also may motivate employees while factoring in the impact on customers, suppliers, employees, the communities in which the company operates, and society more broadly.

Even before the COVID-19 pandemic, boards faced mounting pressure to integrate ESG considerations in corporate strategies and operations, and disclose information relating to ESG matters. The dramatic rise in investor interest in and support for both ESG initiatives and enhanced disclosure of these initiatives shows no sign of abating. Increasingly, how a company addresses ESG matters is viewed as an important part of continuity planning and strategy (regarding both current and future crises), and is closely linked to its resiliency and outlook for long-term success.

Companies should ensure that statements they make about commitments to ESG matters (for example, diversity or environmental protection) are borne out in action. Failure to take action consistent with statements in the company's Securities and Exchange Commission (SEC) filings may support a securities fraud claim on the basis that a stated commitment was false.

Search The Corporate Purpose Debate for more on the company's role in society.

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HUMAN CAPITAL, WORKFORCE, AND CULTURE ISSUES

The COVID-19 pandemic is likely to have long-lasting effects on business needs, the work environment, work preferences, and the market for human capital. In addition to concerns about health and well-being, this includes potential shifts in employee willingness to live and work in highly populated areas, greater interest in and acceptance of work-from-home flexibility, and increased reliance on virtual means for doing business. However, working from home presents potential changes in risk exposure, for example, in the areas of cybersecurity and compliance. It remains to be seen how durable these shifts in attitudes and practices are.

Human capital management issues are critical to corporate culture, and are a key area of board oversight responsibility. These issues cover a wide ground and include:

Practice Pointers

Boards and their advisors should consider the following practical guidance as they establish their priorities and focus areas for 2021.

CORPORATE PURPOSE AND ESG ISSUES

- Consider articulating a company-specific statement of purpose that describes how the goods or services the company provides, and related corporate activities, serve the interests of stakeholders and the broader social good, and consider how to use this purpose as a guide for corporate decisions.
- Set standards and policies regarding sustainability and social responsibility, including environmental issues, lobbying and political contributions, and human rights.
- Discuss with management:
  - their efforts to reassess business practices to identify unintentionally discriminatory practices, for example, in the treatment of customers;
  - the contours and objectives of ESG efforts, such as support for education, health care, food security, supplier diversity, and social justice; and
  - disclosure of ESG matters and related materiality considerations, in SEC filings, in corporate responsibility or sustainability reports, and on the corporate website.
- Keep up to date on developments and trends in ESG disclosure, including SEC statements and guidance, statements by significant institutional investors, shareholder proposal trends, activities of nongovernmental standard setters, peer company benchmarking, and federal legislative activity.

HUMAN CAPITAL AND CULTURE ISSUES

- Monitor management's efforts to support containment of COVID-19 and protect the health and safety of employees (and their families), customers, business partners, and the public.
- Discuss with management their efforts to:
  - improve diversity and inclusion in the workforce, including at senior levels, as well as pay equity and opportunity equity; and
  - protect against discriminatory practices in the hiring, pay, and promotion of employees, promote employees' access to training and opportunities, and invest in worker training, wages, and benefits.
- Work with management to set a "tone at the top" through communications and policies emphasizing a corporate culture that seeks to protect employee well-being, takes action to slow the spread of COVID-19, and promotes ethical behavior, fair dealing, respect for diversity and inclusion, and integrity.

STRATEGIC PLANNING ISSUES

- Support a focus on a long-term sustainable strategy in the face of short-term pressures.
- Consider with management whether (and if so, where) opportunities are likely to emerge that align with the company's strategy, such as opportunities to fulfill an unmet need occasioned by the COVID-19 pandemic or to grow through distressed M&A.
- Monitor management performance using preset benchmarks where possible to determine progress in relation to strategic and operating plans and related budgets, and to assist in providing an "early warning" when a change in strategy or another shift is needed.
- Consider whether business continuity plans are in place and appropriate to the potential risks of disruption identified, including through a discussion with management of relevant contingencies, and continually reassess the adequacy of the plans in light of developments.

MANAGEMENT ISSUES

- Continue to assess how management is handling the current crises.
- Plan for succession of the key executive officers in both normal circumstances and an emergency.
- Replace the CEO if and when the circumstances warrant.
- Align key executives with performance expectations by:
  - determining appropriate incentives;
  - reworking incentive plans, if necessary, in light of the COVID-19 pandemic; and
  - delaying goal setting for incentive plans until the uncertainty has subsided, or building in flexibility with respect to any goals set.

- Talent management, including employee recruitment, promotion, and retention.
- Employee health and safety.
- Fair compensation and benefits, including minimum wage, pay equity, and paid leave.
- The extent of diversity, equity, and inclusion at various levels in the company, including upper management.
- Training and career development initiatives.
- Workforce management issues, including layoffs.
- Efforts to combat discrimination, harassment, and bullying.
- Treatment of whistleblowers.

Human capital measures will be a major focus during the upcoming proxy season, given growing interest from investors in these matters. Companies must comply with recent amendments to Regulation S-K that require disclosures in the annual Form 10-K (as well as other SEC filings), to the extent

SHAREHOLDER ENGAGEMENT AND ACTIVISM ISSUES

- Continue to actively oversee and participate in engagement with key shareholders, with an emphasis on learning about shareholder viewpoints and developing enduring relationships.
- Consider with management how various types of shareholder activists are likely to view the company, and its strategies and governance practices, to identify vulnerabilities.
- Confirm that management is monitoring changes in stock ownership.
- Update or activate defense preparation plans with management, including by identifying special proxy fight counsel, reviewing structural defenses, putting a poison pill "on the shelf," and developing a "break the glass" communications plan.

RISK MANAGEMENT ISSUES

- Continue to discuss with management plans to mitigate business risks arising from the COVID-19 pandemic and the health and safety, financial, operational, and compliance issues it presents.
- Review the functioning of internal controls during the COVID-19 pandemic, and consider its impact on the audit.
- Assess whether an up-to-date crisis management plan is in place to assist the company in reacting appropriately, without either under- or over-reacting.
- Reach a well-informed business judgment about what compliance risks are "mission critical."
- Understand and oversee the existing compliance culture, policies, controls, and procedures to identify, prioritize, manage, and mitigate risks, and regularly reevaluate their alignment with key compliance risks facing the company.
- Ensure that the company's information and reporting system is reasonably designed to provide the board with timely, accurate information sufficient to allow the board to reach informed judgments concerning the company's compliance with laws and oversight of risk.
- Ensure that board and committee agendas, minutes, and meeting materials reflect discussions on compliance issues with respect to ongoing oversight, periodic reviews, and deeper dives and special situations that arise.
- Review and confirm the accuracy of the company's public disclosures about risks facing the company, and reassess the adequacy of the company's disclosure controls and procedures in light of the COVID-19 pandemic.
- Discuss with management and review any significant changes to corporate disclosures (for example, updating risk factors, withdrawing or modifying earnings guidance, revising the management discussion and analysis (MD&A) and financial statements) and SEC requirements.
- Consider whether, due to the COVID-19 pandemic, additional efforts are necessary to protect against selective disclosure and insider trading, including any changes to insider trading or other policies.

BOARD COMPOSITION ISSUES

- Position the board to provide guidance and oversight during the COVID-19 pandemic, for example, by:
  - scheduling in advance special board meetings or information conference calls over the next three to four months, which can be cancelled if not needed; and
  - considering whether contingencies are in place if a board quorum is not available.
- Consider board refreshment mechanisms, including age and tenure limits and individual director evaluation.
- Base director re-nomination decisions on an assessment of relevant expertise and time commitment, as well as actual performance, and avoid treating the re-nomination decision as a foregone conclusion.
- Recruit qualified directors with relevant expertise and the requisite time commitment, taking into account diversity considerations.
- Evaluate issues of board and committee leadership, ensuring that leadership is in place to provide a strong (albeit generally supportive) counterweight to management.

Search Board Considerations for an Uncertain 2021 for the complete online version of this resource, including additional practice pointers and views on top issues for 2021.

material to an understanding of the company's business, describing the company's human capital resources, including any human capital measures or objectives the company focuses on in managing its business.

Search What's Market: Human Capital Management Disclosures for information on recent human capital management disclosures by US SEC reporting companies.

STRATEGIC PLANNING FOR LONG-TERM SUSTAINABLE VALUE

The board should devote attention to the long-term strategy of the business and the risks related to that strategy. Discussion of strategic issues and associated risks should account for a significant portion of board meeting time. In the current environment, in which vulnerabilities related to business continuity evolve rapidly, the board should focus on the fundamental drivers of the business and how those forces may be impacted.

To guide corporate strategy and oversee management's performance in a fast-moving time of business disruption, the board should closely monitor shifting conditions and changing expectations and consider any strategic opportunities or risks they present. This may require rethinking how the company does business, for example, related to changing customer behaviors, consumer demand, or reliability in the supply chain. New opportunities for M&A also may arise. The board should be prepared to adapt the corporate strategy.

The amendments to Regulation S-K also require, to the extent material to an understanding of the general development of a company's business, disclosure of material changes to a previously disclosed business strategy (for more information, search SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors under Regulation S-K on Practical Law).

MANAGEMENT DELEGATION, PERFORMANCE, SUCCESSION, AND COMPENSATION

The COVID-19 pandemic presents complex issues for boards to navigate in their oversight of management. The board's role requires monitoring management activity, assessing whether management is taking appropriate action, and providing additional guidance and direction to the extent that the board determines is prudent. Staying well-informed of developments within the company, as well as external developments, provides the foundation for board effectiveness. While directors may be tempted to dig in and function at a level similar to corporate officers in times of crisis, directors who act as managers risk losing the exculpatory protection typically available to directors. Undue second-guessing of management decisions may also lead to risk aversion and a lack of accountability on their part.

Difficulty in predicting with certainty how the economic environment will change presents challenges for executive compensation. In annual compensation reviews, boards should be mindful of these uncertainties, as they relate to both the company's interest in treating executives fairly and rewarding hard work and performance, and the perception of executive compensation decisions given any employee furloughs, layoffs, or other changes in headcount and the intensified scrutiny of these matters during and after an economic disruption. Incentive compensation should be appropriate to the circumstances, including the variety of potential outcomes for company performance over the next 12 to 18 months.

Management succession continues to be a key board priority, and boards should review emergency succession plans for the CEO and other key officers to ensure they are up to date. The board should understand who is positioned to immediately step into those roles should an executive become incapacitated. (For more information, search Planning for Leadership Succession and Unexpected CEO Transitions on Practical Law.)

SHAREHOLDER ENGAGEMENT AND ACTIVISM

Directors should understand shareholder viewpoints and ensure shareholders are informed about corporate strategy, key board decisions, and the rationales for those decisions. Engaging with significant shareholders to build a trust relationship based on transparency and understanding should be a board priority. Among other benefits, these efforts may increase shareholders' willingness to support the board and management in the face of an activist campaign or a proxy contest.

In times of crisis, the risk of fraud or other serious misconduct by employees may increase, as may the risk of shareholder derivative litigation premised on the board's failure to provide adequate oversight of compliance and related information systems and controls.

With increased volatility in the stock market, and as hedge fund war chests continue to grow, hostile takeover activity and other shareholder activism threats are increasing. Vulnerabilities may change drastically as the economic impact of the current crises continues to unfold, particularly for companies in hard-hit industries or that have over-leveraged. Boards should expect well-capitalized activists to exploit the enhanced vulnerability of target companies. The same applies to unsolicited takeover bids by well-capitalized strategic buyers.

The board should ensure that the company is ready to respond, including through a review of takeover and activist preparedness with financial and legal advisors. This includes a review to ensure that the company has an appropriate team and communications protocols, state-of-the-art bylaw protections, and up-to-date poison pills. If the company is approached by an activist, the board and management should consider the issues they raise and not automatically default to a defensive mode.

RISK MANAGEMENT, CRISIS PREPAREDNESS, AND COMPLIANCE

Key risks that currently should be top of mind for most boards relate to the COVID-19 pandemic, cybersecurity and data protection, and legal compliance. The board and management should take steps to plan for a crisis so that the company is able to react quickly and with assurance.

In times of crisis, the risk of fraud or other serious misconduct by employees may increase, as may the risk of shareholder derivative litigation premised on the board's failure to provide adequate oversight of compliance and related information systems and controls. This claim requires that plaintiffs allege with particularity facts showing that directors failed to implement any reporting or information systems or controls or, having implemented such systems and controls, consciously failed to monitor or oversee operations, effectively disabling themselves from being informed of compliance risks that required their attention.

The Delaware courts have emphasized that, on the right set of facts, director passivity regarding oversight of regulatory or legal compliance risk can constitute bad faith, as an intentional dereliction of duty or intentional disregard of a known risk or duty to act. Recent cases confirm the serious nature of directors' oversight duties regarding compliance and risk, and the litigation risks associated with failure to demonstrate in corporate records that directors are attending to important compliance and other risks facing the company. While it may be difficult to state a claim for failure of oversight, with access to books and records and an egregious set of facts, the Delaware courts will entertain these claims, and boards should continue to focus on oversight of key areas.

At the same time, Delaware courts have expressly rejected extension of failure of oversight claims to business risk as distinct from compliance risk. Therefore, a claim of failed oversight outside of the context of mission critical and regulatory compliance risks should be assessed on the basis of the duty of care. While a duty of care failure alone will not give rise to personal liability due to exculpatory charter provisions, directors and their advisors nevertheless should take special care to ensure that they are meeting that standard, as well as the standard of good faith.

The hallmark of fiduciary governance is informed, deliberative, and objective decision-making that is free of conflict. However, boards and corporate leaders currently must navigate an unusual degree of complexity because of the COVID-19 pandemic's unknown duration and continuing economic impact (as well as the longer term impact on consumer behavior and demand, workforce concerns, and the supply chain), the current environment of heightened political uncertainty, and concerns about social inequities and injustice. This complexity requires heightened attention to maintaining appropriate information flow to directors and ensuring the board reserves sufficient time for deliberation so that they reach an informed judgment.

Search Board Oversight of Compliance for more on the board's compliance oversight obligations.

Search Fiduciary Duties of the Board of Directors for more on fiduciary governance.

BOARD COMPOSITION AND SUCCESSION

In connection with their annual evaluation and re-nomination processes, the board should consider whether its composition is appropriately relevant and attend to refreshment mechanisms. Individual director evaluation should be a component of that consideration. For example, to guide organizations through these unusual times, boards require high-energy directors who are not "overboarded," a problem that becomes more acute when directors serving on several boards may be juggling several crises simultaneously. Boards also should consider their own resiliency, including what mechanisms are in place to ensure that the board can continue to operate if a quorum cannot be achieved because directors are unavailable.

Board composition and refreshment, and related company disclosures, are under increased scrutiny by shareholders (including activists). Large institutional investors, such as BlackRock, State Street, Vanguard, and the New York City Pension System, are prioritizing board diversity. Recently, California enacted a requirement that boards of publicly traded companies headquartered or incorporated in California include at least one member of underrepresented communities by the end of 2021, with additional increases required over time depending on board size, as well as significant fines for violations of the mandate. The law, AB 979, is similar to the California law enacted in 2018 (SB 826) that required boards to include more women.

Search Board Composition, Diversity, and Refreshment for more on board composition and succession.

Search What's Market: US Board Gender Diversity Requirements and Investor Voting Guidelines (2020) for more on board gender diversity.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.