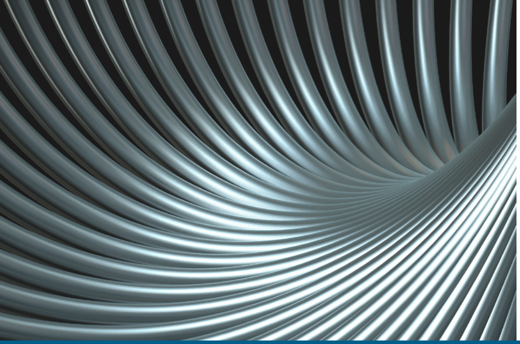

Sidley Perspectives

ON M&A AND CORPORATE GOVERNANCE

DECEMBER 2020

IN THIS ISSUE

ANALYSIS

Sharing Board Meeting Minutes With Independent Auditors: A Litigator's Perspective 2

Steps for Corporate Boards Serious About Improving Diversity in the Boardroom 4

NEWS

JUDICIAL DEVELOPMENTS

Finally, Some COVID-19-Related M&A Guidance: Delaware Court of Chancery Issues Decision Analyzing MAE and Ordinary Course Provisions During COVID-19 6

Delaware Court of Chancery Invokes Rarely Successful "Fraud-on-the-Board" Theory, Permitting Duty of Loyalty Claims to Proceed 7

Delaware Supreme Court Reaffirms Import of Deal Value In Resolving Appraisal Petitions................. 8

Under Delaware Law, Appraisal Actions Do Not Constitute "Securities Claims" Covered by D&O Policy 9

LEGISLATIVE DEVELOPMENTS

House Passes Bill to Delist Foreign Companies From U.S. Stock Exchanges.. 10

SEC DEVELOPMENTS

SEC Charges Company for Internal Controls Violations When It Implemented a Stock Buyback Plan Just Before Resuming Merger Discussions 11

CORPORATE GOVERNANCE DEVELOPMENTS

Nasdaq Aims to Increase Board Diversity Through New Proposed Listing Requirements 12

BlackRock Announces Plans to Vote Against Directors and Support Shareholder Proposals More Frequently in 2021 to Spur Action on ESG Matters 13

Coalition Led by State Treasurers Urges Russell 3000 Companies to Disclose Board Diversity Data in 2021 Proxy Statements...14

Influential Working Group Releases Practical Guidance for Hosting Virtual Shareholder Meetings..15

SIDLEY RESOURCES.. 16

SIDLEY EVENTS... 17

SIDLEY SPEAKERS 17

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ANALYSIS

SHARING BOARD MEETING MINUTES WITH INDEPENDENT AUDITORS: A LITIGATOR'S PERSPECTIVE

By David A. Gordon, Michael D. Warden, and Ross O. Kloeber[1]

Well-crafted minutes from board of directors' meetings are critical to memorializing the care and consideration directors undertake in connection with their corporate decisionmaking and oversight activities. Independent auditors, who gather evidence sufficient to support their opinions on public companies' financial statements and internal controls over financial reporting, generally require access to these minutes as part of their audit work. Given the sensitive nature of board meeting minutes, any exhibits to those minutes, and board materials, and given that they may include privileged information and/or attorney work product, disclosure to independent auditors can present various risks, including arguments in government investigations or in litigation with third parties that sharing information with the auditor constitutes a waiver of attorney-client privilege and/or attorney work product protection. This article provides a general discussion of these risks as well as practice tips for reducing these risks and preserving work product protection when sharing board materials with independent auditors.

Waiver of Attorney-Client Privilege and Work Product Protection

Both the attorney-client privilege and work product protection may apply to board meeting minutes. As a practical matter, both protections operate similarly to the extent that they shield information from disclosure in litigation. The differences between them, however, can be particularly important in the context of determining whether a waiver has occurred through disclosure to a third party, including an independent auditor.

At common law, courts protect confidential communications made between, or on behalf of, attorneys and their clients for the purpose of providing legal advice from disclosure, including disclosure in litigation and government investigations. The purpose of the privilege is to "encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[2] Generally, any disclosure of an attorney-client communication outside of the scope of the attorney-client relationship may result in a waiver of the applicable privilege.

The work product doctrine generally protects materials prepared in anticipation of or in connection with litigation. The doctrine applies to (1) documents and tangible or intangible things (2) that were prepared in anticipation of litigation (3) by a party or by, or for, a representative of the party, to the litigation. In most jurisdictions, the primary question is whether the document or tangible or intangible thing was created "because of" actual or anticipated litigation.[3]

Unlike with respect to attorney-client privilege, mere disclosure of attorney work product to a third party does not necessarily result in waiver of work product protection. Instead, under the most widely-followed variation of the rule, disclosing work product to a third party only waives the applicable protection where that third party is an adverse party or, as stated by one court, where "such disclosure, under the circumstances, is inconsistent with the maintenance of secrecy from the disclosing party's adversary [in the relevant litigation]."[4] This is because the "attorney-client privilege and the work product doctrine serve different purposes; the former protects the attorney-client relationship by safeguarding confidential

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2 *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981).

3 *United States v. Deloitte, LLP*, 610 F.3d 129, 140 (D.C. Cir. 2010).

4 *Rockwell Int'l Corp. v. U.S. Dep't of Justice*, 235 F.3d 598, 605 (D.C. Cir. 2001).

communications, whereas the latter promotes the adversary process by insulating an attorney's litigation preparation from discovery."[5] Put another way, courts examine whether the party receiving the information would be considered to be an adversary or a "conduit to the adversary."[6]

Risks to Attorney-Client Privilege and Work Product Protection When Sharing Board Minutes With Independent Auditors

Because independent auditors are third parties for purposes of the attorney-client relationship and therefore outside of its scope, disclosure of board meeting minutes including attorney-client communications to independent auditors almost always effects a waiver of the privilege.[7] But the same is not necessarily true when a company shares board meeting minutes including information constituting attorney work product, such as evaluations of ongoing or threatened litigation that are discussed in board meetings.[8]

The majority of courts that have considered the question have determined that disclosing attorney work product related to ongoing or anticipated litigation to independent auditors does not effect a waiver of work product privileges.[9] These courts have focused their analysis on two primary questions: (1) whether the independent auditor is an "adversary" as contemplated within the work product doctrine and (2) whether the disclosing company had a reasonable expectation that the information disclosed would remain confidential.

Courts generally have rejected the contention that an independent auditor is an "adversary" for purposes of the work product doctrine, because an *independent* auditor cannot be "adverse" to its audit client. Those courts have reasoned that, although an independent auditor could be a "potential" adversary in the future, this mere potential does not create an adversarial relationship so as to constitute a waiver of the work product protection, as that doctrine is exclusively applicable to actual or threatened litigation.

With respect to the second question, confidentiality agreements or other confidentiality obligations play an important role. Courts consider whether the specific disclosures in question were consistent with a "maintenance of secrecy"[10] and whether there was a reasonable basis for believing that the independent auditor would keep the disclosed material confidential. Auditors generally owe duties of confidentiality to their clients, both as a matter of professional standards and as a matter of contract. In this context, courts consider, among other things, whether those duties are sufficiently clear, whether they be set forth in engagement letters, supplemental agreements, or professional standards.

In short, unlike disclosure to an independent auditor of any attorney-client communications in board meeting minutes, disclosing attorney work product reflected in board meeting minutes typically does not in itself amount to a waiver of the attorney work product protection. Proper management of the materials, however, can help ensure confidentiality and maintain the protection.

Practice Tips for Preserving Privilege and Work Product Protection When Sharing Board Minutes With Independent Auditors

In-house and outside counsel crafting board meeting minutes and/or facilitating an independent auditor's review of the minutes should consider the following:

- When drafting board meeting minutes and determining whether and what supporting materials should be attached, it is important that sufficient detail is provided in order to

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5 *Deloitte*, 610 F.3d at 139-40.

6 *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441, 447 (S.D.N.Y. 2004).

7 *In re Juniper Networks, Inc. Sec. Litig.*, 2009 WL 4644534 at *2 (N.D. Cal. Dec. 9, 2009) ("[T]he Audit Committee's disclosure of the substance of the [attorney-client] communications to [company's] outside auditors effected a waiver of the privilege.").

8 *Deloitte*, 610 F.3d at 139-40.

9 *Id.* at 139 (collecting cases); see also *United States v. Petit*, 438 F. Supp. 3d 212, 214 n. 2 (S.D.N.Y. 2020); *SEC v. Berry*, 2011 WL 825742 at *7 (N.D. Cal. Mar. 7, 2011).

10 *Deloitte*, 610 F.3d at 141.

memorialize the care and consideration undertaken by the board. When considering whether attorney-client communications and/or attorney work product should be included in board meeting minutes, however, it is also necessary to weigh the risk of possible waiver of any applicable attorney-client privilege and/or work product protections with respect to the sufficiency of detail provided.

- To the extent attorney-client communications and/or attorney work product are included in board meeting minutes, determine which privilege and/or protection may apply to them in order to evaluate the necessary precautions to avoid a waiver when sharing them with an independent auditor. That is, consider whether material is protected by attorney-client privilege, attorney work product or both.
- Although disclosure of attorney work product to an independent auditor alone likely will not be found to constitute a waiver, to protect the work product from potential disclosure to a litigation adversary and waiver and otherwise to minimize risk consider:
  - Ensuring that there is sufficient confidentiality language in any engagement letter with the auditor and/or executing a separate confidentiality agreement pertaining to the auditors' expected use of the minutes.
  - Memorializing—in a manner consistent with an auditor's responsibilities—an independent auditor's expected uses and the parties' expectations of confidentiality in a cover letter or email to the auditor when providing access to board meeting minutes for review.
  - Requesting that auditors allow counsel for the company to review material in the auditors' workpapers or otherwise in their possession that may be subject to a company privilege or work product protection prior to production in response to a governmental request or civil litigation subpoena, so as to allow the company to assert that material protected by attorney work product should be withheld or redacted.
  - Refraining from providing draft versions of board meeting minutes, and allowing auditors to review minutes only once they have been finalized.

STEPS FOR CORPORATE BOARDS SERIOUS ABOUT IMPROVING DIVERSITY IN THE BOARDROOM [11]

By Beth E. Berg and Reuben Zaramian[12]

The painful national discussion on race and inequality has put a renewed spotlight on diversity and inclusion, causing public company directors to re-examine—and for some, examine for the first time—diversity in the boardroom.

Although the qualitative and quantitative benefits of boardroom diversity are compelling, too few U.S. public company boards include a meaningful number of diverse directors. A 2019 study by the Alliance for Board Diversity showed that women and minorities combined represented just one-third of Fortune 500 directors, which means that two-thirds of Fortune 500 directors are white males. An even smaller percentage of small-cap company directors are diverse—one study shows that board diversity in small-cap companies is at least a decade behind the progress made by large-cap companies.

So why do most public companies continue to struggle with boardroom diversity in 2020? In our view, it is not because boards do not want to improve diversity or because boards have

11 Reproduced with permission. Published Oct. 16, 2020. Copyright 2020 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bloombergindustry.com

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not tried to enhance diversity. Instead, it is due to how boards identify what they want in new directors and how boards evaluate potential director candidates.

Below are steps boards can take to address these issues and make progress toward enhancing diversity in the boardroom.

1. Acknowledge the Purpose of Boardroom Diversity

A commitment to diversity involves an acknowledgment of the fundamental value to companies and shareholders of leadership that reflects a diversity of thought, perspective, and experience. It involves avoiding tokenism and "check-the-box" mentalities — the problem is not addressed by adding a single woman or minority director to the board. The search for diversity requires the harder task of intentionally seeking individuals who will bring a different perspective and outlook to board discussion. Plus, there is strength in numbers; studies show that greater diversity in the boardroom has a positive correlation with innovation intensity and output.

2. Expand the Director Skills Matrix

Consider what each member of the board brings to the boardroom. Determine which characteristics may be missing due to the natural tendency for people to value more highly traits and experience that they have or perceive about themselves. Are there blind spots? Is the board focused on characteristics that unnecessarily limit the pool of qualified candidates (e.g., public company board or CEO experience, investment banking experience)? What else could be beneficial that is currently not adequately represented in the boardroom (e.g., industry experience, interpersonal/conflict resolution skills, communications expertise, HR expertise, particular customer or employee perspectives, etc.)? For example, if the company primarily markets to a specific type of customer (e.g., women, a specific type of physician), is there sufficient representation of that perspective in the boardroom?

3. Reconsider the Process for Identifying Director Candidates

To the extent boards recruit from the networks of their own directors and the CEO, potential candidates may be limited to those who are similar to existing board members not only in terms of educational, socioeconomic, and experiential backgrounds, but also in terms of gender and race.

However, there is a wide variety of resources available to boards searching for qualified candidates, including executive search firms and non-traditional sources such as trade associations and organizations focused on identifying and vetting diverse director candidates (e.g., the NYSE Board Advisory Council, which helps identify talented diverse candidates interested in serving on boards). When outsourcing the identification of candidates (e.g., to an executive search firm), it is critical for boards to understand, and provide direction regarding, the sources used to identify potential candidates.

Many companies use outside resources to some degree, and they often start with a large and diverse pool of candidates. However, just like the 2020 Democratic Party primary, all too often only white male candidates remain at the end of the process, which raises another key issue — how boards evaluate the candidates identified.

4. Reconsider How Director Candidates Are Evaluated

This is where a commitment to diversity most often breaks down. It does little good to have a wide pool of candidates if those candidates are ultimately assessed using the wrong criteria.

In evaluating director candidates, it is important to bear the following in mind:

- So-called objective metrics may be inherently biased in favor of the typical white male candidate. For example, requiring board candidates to have public company board experience or to have served as a CEO or CFO of a public company leads to an overwhelmingly white male pool of "qualified candidates." Although boards should include directors with public company board (or C-suite) experience, certainly not all directors need to bring those same experiences and competencies to the boardroom.

- Unconscious bias may cause directors to favor those who look and act like themselves and judge more harshly those who differ from themselves. Thus, it is important to be aware of this natural human tendency when reviewing CVs and interviewing candidates, and consider ways to counteract it. For example, when reviewing credentials, imagine that the candidate is of a different gender or ethnicity (e.g., when reviewing the CV of a white male candidate, pretend it is the CV of a minority female). Similarly, merely reminding oneself of this natural human tendency prior to interviewing director candidates may limit its effects.
- Focusing on people who will "fit in" can be a way of ensuring boardroom homogeneity. Collegiality and culture are important, but the benefits of boardroom diversity are achieved only by having a mix of people who do not all look or think the same way.

NEWS

JUDICIAL DEVELOPMENTS[13]

Finally, Some COVID-19-Related M&A Guidance: Delaware Court of Chancery Issues Decision Analyzing MAE and Ordinary Course Provisions During COVID-19

In AB Stable, *the Delaware Court of Chancery found that no MAE occurred but held that the seller breached the ordinary course covenant by making COVID-19-related changes to the business, which created a walk-away right for the buyer.*

The Delaware Court of Chancery recently allowed a buyer to walk away from an acquisition due to, among other things, the seller's failure to satisfy the interim operating covenant requiring the seller to operate in the ordinary course because of changes made to the operating business in response to the COVID-19 pandemic. *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC* (Del. Ch. Nov. 30, 2020). The opinion, penned by Vice Chancellor Laster, is the first decision offering post-trial guidance as to the application of material adverse effect (MAE) and ordinary course provisions during the pandemic. Its guidance on the application of these provisions should be of interest for all negotiating M&A deals and other commercial agreements generally, and during the COVID-19 pandemic in particular.

Plaintiff sought to sell a subsidiary that owned an approximately $5.8 billion portfolio of luxury hotels. The deal was signed in September 2019 and was slated to close in April 2020. Due to COVID-19, shortly before the planned closing, the seller made material changes to its business. These included closing two hotels entirely, gutting operations at 13 others, terminating or furloughing staff, and cutting spending on marketing and capital expenditures. The seller filed a complaint seeking specific performance to force a closing; the buyer responded with counterclaims contending, among other things, that it had no obligation to close because an MAE occurred, and the seller breached the ordinary course provision. The Court's rulings on both of these points are highly instructive.

MAEs

MAE provisions allocate between contracting parties the risk between signing and closing in the event of a significant downward shift in the target company's valuation. Usually, market or industry risk is allocated to the buyer, while company-specific risk is allocated to the seller. However such provisions typically list exclusions that might qualify as being material and adverse, but are agreed by the parties *ex ante* to be without recourse.

Here, the contract included an exception for "natural disasters and calamities," which the Court held covered the COVID-19 pandemic. This is the first such ruling and provides

13 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Julia L. Bensur, Robert M. Garsson, Charlotte K. Newell, and Andrew W. Stern.

interpretive guidance for similar MAE provisions going forward. This may be of limited utility, however, because many contracts executed since early 2020 also have incorporated a belt-and-suspenders exclusion accounting specifically for a "pandemic."

Ordinary Course Provisions

The buyer also claimed that a closing condition was not satisfied because the seller made COVID-19-related changes to the operating business that violated the ordinary course provision. In response, the seller attempted to frame its actions as an "ordinary response to an extraordinary event," thereby satisfying the ordinary course provision. The Court sided with the buyer, pointing to precedent defining "ordinary" course to mean the "ordinary routine of conducting business," with reference to prior practices. The Court further explained that such provisions are intended to "to reassure a buyer that the target company has not materially changed its business or business practices during the pendency of the transaction." Reference to past practice thus excluded actions taken solely in response to the "extraordinary." This finding was reinforced by the particular language of the parties' contract, which required the business to be operated "*only* in the ordinary course of business *consistent with past practice,*" which narrowed the inquiry to just the business at hand, even excluding reference to how comparable businesses might have operated.

One open question following this decision is whether legally mandated conduct—perhaps, shuttering a business due to a government order—could constitute a breach of the ordinary course covenant. In dicta, the Court noted such an argument might carry weight, but even assuming as much, the seller had not proven the claim at trial.

Putting it All Together: MAE and Ordinary Course Provisions

AB Stable *stands as a comprehensive guide to analyzing claims relating to MAE and ordinary course provisions during the COVID-19 pandemic.*

The Court also rejected the seller's argument that the MAE clause and ordinary course provision should be read in tandem. Although the parties chose to allocate pandemic risk to the buyer through the "calamities" exception in the MAE clause, that did not obviate the seller's ordinary course obligations during the pandemic. In making this finding, the Court focused on the plain language of the parties' agreement, highlighting: (1) that these were separate provisions that implicated separate closing conditions; (2) that these provisions could have cross-referenced each other but did not; and (3) that each traditionally seeks to address different forms of risk (MAEs, a decreased valuation; ordinary course provisions, changes to the way in which the target business is operated).

While it is unclear as of this writing whether there will be an appeal from this ruling, for now it stands as a comprehensive guide to analyzing claims relating to MAE and ordinary course provisions during the COVID-19 pandemic. Buyers and sellers alike should heed its guidance carefully and focus on the plain language of MAE and ordinary course provisions to ensure a mutual understanding of how much latitude a seller will have to operate the business during these extraordinary times, mindful that Delaware courts likely will construe and enforce their contract literally.

Delaware Court of Chancery Invokes Rarely Successful "Fraud-on-the-Board" Theory, Permitting Duty of Loyalty Claims to Proceed

The Delaware Court of Chancery recently allowed to proceed post-closing claims that a merger was completed at an inadequate price, premised largely on allegations that the company's CEO and chairman was conflicted and tilted the process in favor of the buyer. In *re Mindbody, Inc. S'holders Litig.* (Del. Ch. Oct. 2, 2020). This decision serves as a reminder for fiduciaries considering change of control transactions—including the Court's reminder that "the sins of just one fiduciary can support a viable *Revlon* claim."

In the *Mindbody* litigation, plaintiffs alleged that three company fiduciaries were motivated by personal ends to favor the ultimate buyer in the company's merger. In so alleging, plaintiffs pled *"Revlon"* claims: the *Revlon* doctrine requires that fiduciaries maximize the sale price in a change of control transaction, though it grants them significant flexibility in determining how to achieve that objective. Plaintiffs alleged that the challenged fiduciaries tilted the transaction in favor of one bidder (the buyer), and the company's board therefore breached its fiduciary duties.

In Mindbody, *the Delaware Court of Chancery also found that the target company's failure to publicly disclose positive quarterly results before the stockholder vote may have rendered misleading its proxy statement disclosure describing the per share merger consideration price as a 68% premium to the then-current trading price.*

Typically, a stockholder plaintiff can sustain a claim that directors breached their duty of loyalty only by adequately alleging that a majority of the pertinent board was conflicted. There are, however, exceptions. One is the so-called "fraud-on-the-board" theory, where a conflicted fiduciary fails to disclose material information to the board, meaning information "of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking." In practice, this is a two-step inquiry: (1) were the alleged conflicts material to the pertinent fiduciary and (2) would other directors have viewed the information as material.

Vice Chancellor McCormick found that the plaintiffs adequately alleged that the company's CEO (1) had a material conflict and (2) did not disclose that conflict to the remainder of the board. This was based on a number of factual allegations, including:

- The CEO suggested that he preferred not to run a public company and wished to sell "to a private equity fund that would agree to employ him" post-deal.
- He later personally received an expression of interest from the would-be buyer and facilitated calls to resemble an "employee recruitment process" but "did not immediately disclose" the expression of interest to the board and told management to do the same.
- He did not tell the board about his interactions with the would-be buyer.
- He "eliminated bidders for whom he did not wish to work from the sales and go-shop process."

The Court found that "viewed collectively," these allegations were adequate to support plaintiffs' fraud-on-the-board theory and withstand a motion to dismiss, notwithstanding the board's other transaction-related efforts. These included the formation of a transaction committee, which the Court noted somewhat cut against plaintiffs' claims, but its characteristics (including an initially limited mandate, unclear formation date, and its deference to the CEO) left the Court unconvinced that it sufficiently mitigated the CEO's alleged conflict for purposes of this pleading-stage determination.

The *Mindbody* litigation is a reminder of the importance of candid board-level disclosure regarding the interests of those in an ongoing corporate sales process. This includes not only disclosure regarding director interactions with bidders and bankers, but also personal interests that could lead a director to make decisions while thinking of anything other than acting in the company's best interests. Parties should err on the side of over-sharing, knowing that the disclosures may be judged in the harsh glare of hindsight.

Delaware Supreme Court Reaffirms Import of Deal Value In Resolving Appraisal Petitions

The Delaware Supreme Court recently reaffirmed that, absent significant market or process concerns, deal price should be a significant (if not outcome-determinative) factor in the appraisal of Delaware corporations. *Brigade Leveraged Capital Structures Fund Ltd., et al. v. Stillwater Mining Co.* (Del. Oct. 12, 2020).

In 2017, Sibayne Gold, Ltd. acquired Stillwater Mining Co. in a reverse triangular merger that entitled the holder of each Stillwater share to $18 of merger consideration at closing. Petitioners, former Stillwater stockholders, perfected their appraisal rights and argued that a flawed deal process made the $18 per share deal price unreliable. This included an increase in commodity prices between signing and closing that increased Stillwater's value by 9%.

In resolving an appraisal petition, the Court of Chancery must determine the "fair value" of the petitioner's stock (i.e., its pro rata share of the value of the company as a going concern), exclusive of any benefit that arises from the merger (e.g., synergies). A rare feature of appraisal proceedings is that the Court has discretion to fashion the appropriate remedy based on the parties' presentations; neither party bears the burden of proof.

The Stillwater *decision suggests that "deal price" will be strongly indicative of fair value in many third-party, public company transactions absent transaction process flaws.*

In a series of relatively recent decisions (e.g., *DFC*, *Dell*, and *Aruba Networks*) which were covered in prior issues of *Sidley Perspectives*, the Delaware Supreme Court has sharpened the appraisal lens to focus on deal price, absent circumstances suggesting the process leading to that price was undeserving of that deference. Otherwise stated, recent decisions have indicated that if a deal reflects "objective indicia of reliability," the deal price will deserve "heavy" if not "dispositive" weight. Here, the Supreme Court affirmed the trial court's finding that the deal price reflected fair value due to five factors: (1) the transaction was at arm's length with a third party; (2) the board of directors was not subject to any meaningful conflicts; (3) the buyer completed a diligence process; (4) the target negotiated multiple deal price increases; and (5) no bidders emerged post-signing.

The *Stillwater* decision provides added comfort for buyers considering the potential for post-closing appraisal claims. But that comfort comes with a caveat: buyers do not have real-time, first-hand knowledge of the target's deal processes, and thus do not have perfect vision into potential appraisal exposure. But this spate of recent decisions suggests "deal price" will be strongly indicative of fair value in many third-party, public company transactions absent transaction process flaws.

Under Delaware Law, Appraisal Actions Do Not Constitute "Securities Claims" Covered By D&O Policy

The Delaware Supreme Court reversed a decision of the state's Superior Court, holding that an appraisal action arising from Vista Equity Partners' acquisition of Solera Holdings, Inc. did not fall within the definition of a "Securities Claim" for the purposes of coverage under Solera's primary and excess directors' and officers' insurance policies (D&O Policies). *In re Solera Ins. Coverage Appeals* (Del. Oct. 23, 2020). The decision cautions that such policies should be carefully reviewed on a periodic basis and that would-be buyers should do the same during diligence.

We covered the underlying Solera appraisal action in our Summer 2018 issue of Sidley Perspectives, *which reinforced the concept that deal price does not always serve as a floor in determining fair value.*

Solera was acquired by Vista Equity Partners in March 2016. At the time, the company's primary D&O Policy covered any "Loss resulting solely from any Securities Claim made against an Insured during the Policy Period for a Wrongful Act" and defined a "Securities Claim" to cover "any actual or alleged violation of any federal, state or local statute, regulation, or rule or common law regulating securities, including but not limited to the purchase or sale of, or offer to purchase or sell, securities." A majority of Solera's stockholders approved the merger, and the transaction closed at $55.85 per share.

Several days later, a number of stockholders filed an appraisal action to determine the fair value of their shares. The stockholders asserted that the fair value at the time of the merger was $84.65 per share. Chancellor Andre G. Bouchard determined after trial that the fair value was $53.95 per share. After the trial, Solera requested coverage from its carriers, not for the judicially determined fair value of the shares, but for the prejudgment interest amount accrued on that payment and the defense expenses incurred in defending the action. The insurers denied coverage, rejecting Solera's assertion that expenses incurred in the appraisal case were covered by the definition of "Securities Claim" in the D&O Policies.

Solera soon filed a breach of contract claim, contending that the appraisal action constituted a Securities Claim because, "among other things, the petitioners alleged a violation of Delaware's appraisal statute, which is a law regulating securities, and the petitioners claimed a host of supposed securities violations in connection with the sales process." The insurers argued in response that there was no "violation" of any law regulating securities because there was no finding of "wrongdoing." In support, the insurers pointed to Section 262 of the Delaware General Corporation Law, which they asserted reflected a neutral proceeding in which a court merely adjudicates the fair value of a company's shares on the date of a merger or acquisition without a finding of "wrongdoing." The Superior Court agreed with Solera, holding that a "violation" under the policy did not require any allegation of "wrongdoing," but the Supreme Court reversed, finding:

- An appraisal action is neutral in nature, and not asserted based on any violation of law because the word "violation" inherently requires some element of wrongdoing. Appraisal under Section 262 is a remedy that "does not involve a determination of wrongdoing."
- Because the appraisal action did not involve the Court's adjudication of any wrongdoing by Solera, it was not premised on a "violation" of law and thus was not a "Securities Claim."
- The remaining issues raised by the parties regarding prejudgment interest and defense expenses were moot upon the determination that appraisal actions do not fall within the definition of "Securities Claim."

The *Solera* litigation is a reminder of the importance of precision in definitions in D&O Policies. In particular, companies contemplating a merger or acquisition should examine the target's insurance policies with these considerations in mind. In light of the Court's determination that appraisal proceedings do not involve an "adjudication of wrongdoing" and therefore would not fall within the definition of a "Securities Claim," companies and insurers alike should take another look at how best to approach D&O coverage to adequately protect their interests.

LEGISLATIVE DEVELOPMENTS

House Passes Bill to Delist Foreign Companies From U.S. Stock Exchanges

On December 2, the U.S. House of Representatives passed S 945, the Holding Foreign Companies Accountable Act, in the same form passed by the U.S. Senate on May 20. President Donald Trump is expected to sign the bill into law. The key effect of S 945 is that, after a three-year period, it could prohibit certain companies from listing and trading their securities on any U.S. stock exchange or through any other method regulated by the SEC if the Public Company Accounting Oversight Board (PCAOB) is prevented from reviewing the companies' audits. A summary of the bill and its potential effects are provided in the Sidley Update available here.

*In November, the SEC's Division of Corporation Finance published new **guidance** setting forth its expectations that China-based issuers provide high quality, reliable financial reporting and fully disclose material risks related to their operations in China. The guidance highlights as a disclosure consideration whether there are restrictions on the PCAOB's ability to inspect the company's audit work.*

During the December 2 House debate, the lead House sponsor of the bill, Rep. Brad Sherman, D-Calif., framed the new legislation as "an investor protection bill" and outlined its potential reach, intent, and goals. He highlighted that the legislation has the power to affect approximately 224 companies currently listed on U.S. exchanges with a combined capitalization of $1.8 trillion. Although the legislation's requirements are not limited to any one country, Rep. Sherman made clear that the primary target is China but that "this is not anti-China, and it is not designed to prohibit the trading of Chinese companies." He said the goal of the law is to provide additional leverage in negotiating with Chinese regulators to reach a cooperative agreement that would allow for the PCAOB to conduct inspections of Chinese firms listed on U.S. exchanges.

Despite the legislation's requirement that the PCAOB be able to "inspect or investigate completely" the preparation of a covered issuer's audit report on a financial statement, Rep. Sherman read a joint statement by Sen. John Kennedy, R-La. (the Senate author of the legislation), and himself which suggested there should be a two-thirds safe harbor principle for audit reports (with the SEC having the discretion to measure "two-thirds" based on total revenue, assets, or some other measurable indicia). They added that it is Congress's expectation that "the Commission will not prohibit trading in the securities of companies in this act as long as not more than one-third of the company's total audit is performed by a firm beyond the reach of the PCAOB inspection."

Once enacted, the SEC will have 90 days to issue rules to implement the law. It is not clear whether it will follow the principles that Rep. Sherman outlined in the joint statement. For more information, see our Sidley Update available here.

SEC DEVELOPMENTS

SEC Charges Company for Internal Controls Violations When It Implemented a Stock Buyback Plan Just Before Resuming Merger Discussions

In October, the SEC announced an enforcement action against Andeavor LLC for internal controls violations relating to a stock buyback plan the company implemented while it was in discussions to be acquired. Andeavor agreed to pay a substantial $20 million civil penalty to settle the charges without admitting or denying liability.

The SEC's order alleges that Andeavor held months of confidential discussions with Marathon Petroleum Corp. beginning in March 2017 about Marathon potentially acquiring Andeavor. In October 2017, the CEOs of the two companies agreed to suspend their discussions. On January 30, 2018, Marathon's CEO asked Andeavor's CEO to resume their discussions, and they agreed to meet on February 23, 2018.

SEC Division of Enforcement: *"Andeavor lacked an effective process for obtaining an accurate and complete understanding of the facts and circumstances necessary to determine whether it was in possession of material non-public information and therefore prohibited from engaging in buyback transactions."*

On February 21, 2018, two days before the scheduled date to resume merger talks, Andeavor's CEO directed the company's CFO to initiate a $250 million stock buyback. Andeavor's prior board authorization required that any buyback must comply with the company's securities trading policy, which prohibited share repurchases (including through a Rule 10b5-1 plan) while the company was in possession of material nonpublic information (MNPI).

On February 22, 2018, Andeavor's legal department approved the company's Rule 10b5-1 plan to buy back shares after concluding that the discussions with Marathon did not then rise to the level of MNPI. Over the next five weeks, Andeavor bought back 2.6 million shares at an average price of $97 per share. Two weeks after completing the buyback, on April 30, 2018, Andeavor announced that it would be acquired by Marathon in a deal that valued Andeavor at more than $150 per share.

The SEC found that Andeavor violated Exchange Act Section 13(b)(2)(B) for failing to have internal accounting controls sufficient to provide reasonable assurance that the stock buyback would be executed in accordance with its board's authorization (i.e., in compliance with Andeavor's securities trading policy). The SEC faulted Andeavor for using an "abbreviated and informal process to evaluate the materiality of the acquisition discussions that did not allow for a proper analysis of the probability that Andeavor would be acquired," including by failing to ask the CEO, who was the "primary negotiator with Marathon," about the likelihood that the parties would agree to a deal. Therefore, the legal department approved the 10b5-1 plan "based on a deficient understanding of all relevant facts and circumstances regarding the two companies' discussions."

The action is instructive as to when a potential M&A transaction may rise to the level of MNPI for purposes of a company's securities trading policy. The SEC found that Andeavor "failed to appreciate that the probability of Marathon's acquisition of Andeavor was sufficiently high at that time as to be material to investors." In a footnote to its order, the SEC reminded that "[i]t is well established that an acquisition need not be more likely-than-not to occur for it to be material," citing *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

In light of this action, companies should be mindful of the timing and process for implementing a stock buyback plan, including the process for assessing whether the company is in possession of MNPI. They should ensure that they consult with all individuals who are reasonably likely to have potentially material information about significant corporate developments and keep a record of those discussions.

The Andeavor enforcement action also warns that the SEC will closely scrutinize internal controls in the context of stock buybacks and may bring charges against companies for alleged MNPI violations under the internal controls provisions as an alternative to pursuing insider trading charges.

CORPORATE GOVERNANCE DEVELOPMENTS

Nasdaq Aims to Increase Board Diversity Through New Proposed Listing Requirements

The push for greater board diversity has intensified in recent years and shows no signs of stopping. Public companies wishing to enhance the diversity on their boards should refer to the article above titled Steps for Corporate Boards Series About Improving Diversity in the Boardroom.

On December 1, the Nasdaq Stock Market LLC filed a proposal with the SEC to adopt new listing standards that would increase the expectations for board diversity and related disclosures at the approximately 3,000 companies listed on Nasdaq's U.S. exchange. If approved by the SEC, the new listing rules would require Nasdaq-listed companies to:

- publicly disclose diversity statistics regarding their boards in a standardized disclosure matrix template
- have, or explain why they do not have, at least two diverse directors, including one who self-identifies as female and one who self-identifies as either an underrepresented minority or LGBTQ+

The SEC published the proposed rule changes in the *Federal Register* on December 11 and will accept public comments on the proposal through January 4, 2021. The deadline for the SEC to approve the proposal is August 8, 2021. Nasdaq has published more than 30 FAQs that clarify several aspects of the proposal and provide practical guidance regarding implementation.

Under the proposal, all Nasdaq-listed companies would be required to annually disclose specified board diversity statistics (gender, race/ethnicity, and LGBTQ+) in Nasdaq's board diversity matrix template (or a substantially similar format) on their websites or in their proxy statements. Disclosure would be required at the board level in the aggregate rather than individually by name. If a director declines to self-identify as female or diverse, the company should reflect that in the "undisclosed" category of the board diversity matrix. Companies must provide the required diversity disclosures within one year after the SEC approves the listing rule. After the first year, companies must provide the board-level diversity data for the past two years.

Nasdaq is proposing a "comply or explain" approach with respect to its heightened expectations for board composition. The proposed rule would require most Nasdaq-listed companies to (1) have at least two diverse directors, including one who self-identifies as female and one who self-identifies as either an underrepresented minority or LGBTQ+

director,[14] or (2) explain on their websites or in their proxy statements the rationale for not meeting the requirement. Nasdaq will confirm that a company has provided an explanation for non-compliance but will not evaluate the substance of the explanation. Nevertheless, Nasdaq provided sample rationale disclosures in its rule proposal for reference (e.g., that a company chooses to define diversity more broadly than Nasdaq by considering national origin, veteran status, or individuals with disabilities).

Smaller reporting companies may satisfy the requirement by having two female directors. Foreign issuers may satisfy the requirement by having either (1) two female directors or (2) one female and one individual who self-identifies as LGBTQ+ or an underrepresented individual based on national, racial, ethnic, indigenous, cultural, religious, or linguistic identity in the company's home country jurisdiction.

Companies would be required to have at least one diverse director within two years after the SEC approves the listing rule and to have at least two diverse directors either within (1) four years of SEC approval for companies listed on the Nasdaq Global Select or Global Market tiers or (2) five years of SEC approval for companies listed on the Nasdaq Capital Market tier.

If a company fails to comply with the proposed board diversity disclosure and composition requirements by the applicable deadline, Nasdaq will give it an opportunity to cure the deficiency before initiating delisting procedures.

Nasdaq-listed companies should evaluate their board composition and related proxy statement disclosures in light of the rule proposal. They should also consider supplementing their D&O questionnaires to request demographic information about directors and their consent to the company publicly disclosing that information.

BlackRock Announces Plans to Vote Against Directors and Support Shareholder Proposals More Frequently in 2021 to Spur Action on ESG Matters

BlackRock announced that for 2021, "given the need for urgent action on many business relevant sustainability issues, [it] will be more likely to support a shareholder proposal without waiting to assess the effectiveness of engagement."

Ahead of the 2021 proxy season, BlackRock Inc., the world's largest institutional investor with more than $7.8 trillion of assets under management, warned boards to make progress on environmental, social, and governance (ESG) issues or be held accountable. On December 10, BlackRock Investment Stewardship released its 2021 Stewardship Expectations, which include updates to its Global Principles and Proxy Voting Policies that will take effect in January 2021. The primary takeaway is that BlackRock plans to vote against directors and support shareholder proposals more frequently in 2021 to spur companies into action on ESG issues such as board and workforce diversity and climate change.

The key updates to BlackRock's policies and guidelines are summarized below.

- ***Expectations for Boards.*** Beginning in 2021, BlackRock is asking U.S. public companies to disclose the race and ethnicity of their directors. BlackRock intends to vote against directors more often in 2022 at companies that are not exhibiting diversity. It also plans to focus more closely on average director tenure in 2021.
- ***E&S Shareholder Proposals.*** If BlackRock believes that a company's approach to an issue that raises material environmental or social risks could be improved or accelerated, BlackRock will vote in favor of a shareholder proposal on the topic if it is reasonable and not unduly constraining to management. This marks a significant shift from BlackRock's historic approach of expressing its views through engagement but giving companies time to address the issue.

14 For purposes of the proposed listing standard, an "underrepresented minority" means an individual who self-identifies as one or more of the following: Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, or Two or More Races or Ethnicities. "LGBTQ+" means an individual who self-identifies as any of the following: lesbian, gay, bisexual, transgender, or a member of the queer community.

- *Climate-Related Risks.* Consistent with the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations and prior engagements, BlackRock clarified that it expects companies (including the 1,000+ unidentified carbon-intensive companies in its "focus universe" for 2021) to disclose plans to align their businesses with the global goal of net zero greenhouse gas emissions by 2050. Also, BlackRock may vote against directors in 2021 at 191 companies that it put "on watch" in 2020 if they fail to make progress toward managing and disclosing climate-related risks.
- *Key Stakeholder Interests.* BlackRock is asking companies to report on how they considered the interests of key stakeholders in their business decision-making. For 2021, BlackRock is "prioritizing a focus universe of approximately 150 companies whose business practices may have resulted in adverse impacts or reflect insufficient management of 'social' sustainability risks."
- *Diversity, Equity, and Inclusion (DEI).* Beginning in 2021, BlackRock is asking U.S. public companies to disclose (1) EEO-1 data highlighting the diversity of their workforce by race, ethnicity, and gender and (2) actions they are taking to advance DEI and support an engaged workforce.
- *Alignment of Political Activities With Stated Policy Positions.* For 2021, BlackRock will request details from companies about their corporate political activities (including trade association memberships) to assess whether they align with the company's public statements on policy issues.

Public companies should review BlackRock's updated policies and expectations for 2021, particularly if BlackRock is a significant shareholder. They should reassess their current business and disclosure practices in light of the updates and determine whether changes are warranted.

Coalition Led by State Treasurers Urges Russell 3000 Companies to Disclose Board Diversity Data in 2021 Proxy Statements

The State Treasurers of Illinois and Connecticut launched the Russell 3000 Board Diversity Disclosure Initiative in October by sending a form letter (like this example) to the boards of all Russell 3000 companies asking them to consider voluntarily disclosing the race/ethnicity and gender of each of their directors in their 2021 proxy statements. The letter was signed by leaders of 20 investor organizations that together hold more than $3 trillion in assets under management, including the New York City Comptroller and CtW Investment Group. The letter reports that many of these organizations are "examining policies to vote against nominating committees with no reported racial/ethnic diversity in their proxy statements and expanding more direct shareholder engagement."

Public companies are increasingly choosing to disclose board diversity metrics in their proxy statements, often on an aggregated basis rather than by individual director. According to a report on the 2020 proxy season from the EY Center for Board Matters, 50% of Fortune 100 companies disclosed the board's racial/ethnic diversity in 2020 compared to 24% in 2017.

The press release announcing the initiative linked to a white paper from the Illinois State Treasurer's office titled The Investment Case for Board Diversity. Citing numerous studies and academic research, the paper concludes that racial/ethnic and gender diversity at the board level is materially and positively correlated to company value and long-term financial performance. According to the paper, "[c]ompanies with a diverse board, inclusive of gender and race/ethnicity, are better positioned to execute good governance, effective risk management, and optimal decision-making, as well as enhanced customer alignment, employee engagement, and transparency, as compared to those with laggard board diversity."

The letter sent to Russell 3000 companies provides an example of model board diversity disclosure where a company supplemented its board skills matrix with categories for demographics on race/ethnicity and gender. Unlike the Nasdaq proposal discussed above, which would require diversity disclosure at the board level, the example discloses diversity characteristics by individual director. Public companies should inform their nominating and corporate governance committees about this initiative and consider whether to make any corresponding changes to their proxy statement disclosures or board composition.

Influential Working Group Releases Practical Guidance for Hosting Virtual Shareholder Meetings

The aspiration of the 2020 Working Group is for companies, investors, and service providers to conduct VSMs in ways that replicate the in-person annual meeting experience for the shareholder as closely as possible in order to foster effective corporate governance.

On December 10, a working group of public company and investor representatives published the Report of the 2020 Multi-Stakeholder Working Group on Practices for Virtual Shareholder Meetings detailing considerations and recommendations for virtual-only shareholder meetings (VSMs) held in the 2021 proxy season and beyond. The Report does not endorse VSMs but rather is a guide for any company that has determined, based on its particular facts and circumstances, to hold its annual meeting virtually. The stated goal "is for companies, investors and service providers to conduct VSMs in ways that replicate the in-person annual meeting experience for the shareholders as closely as possible in order to foster effective corporate governance."

The group was convened in August 2020 by the Rutgers Center for Corporate Law and Governance and was co-chaired by the Executive Director of the Council for Institutional Investors and the CEO of the Society for Corporate Governance. In addition to the public company and investor representatives, the group included a steering committee of the largest VSM service providers and notable corporate governance advisors. The Report expands upon a set of best practices titled Principles and Best Practices for Virtual Annual Shareholder Meetings published by a similar working group convened by Broadridge Financial Solutions in 2018.

The Report is timely as the COVID-19 pandemic prompted a surge in VSMs in 2020 and many public companies are considering whether to hold their shareholder meetings virtually in 2021. According to the Report, 2,367 U.S. companies held VSMs in the first half of 2020 compared to just 318 companies in all of 2019. Appendices to the Report provide VSM statistics for the past three years as well as details about state and federal laws relevant to virtual and hybrid shareholder meetings.

The Report notes that, despite the increased prevalence of VSMs in 2020 and improvements in VSM-related technology, shareholders continue to view VSMs as an inadequate substitute for in-person meetings because they limit interaction and discussion with management and the board. To alleviate some of their concerns, the Report provides practical guidance on various disclosure topics and VSM practices that shareholders will likely expect companies to adopt for future VSMs:

- *Disclosure*—instructions on how shareholders can attend, participate and submit questions; reasons for using a virtual-only format
- *Preparation*—company training and rehearsals; communication with shareholder proponents; testing shareholders' internet connectivity
- *VSM Platform*—audio or video format; voting; questions; posted content
- *Assistance for Attendees*
- *Proceedings of the Meeting*—announcements; shareholder proposals; Q&A session
- *After the Meeting*

Finally, the Report identifies 11 "optimal and emerging" practices that some companies used to enhance their VSMs in 2020 that other companies may consider adopting, such as posting a transcript of the meeting (including the Q&A session) on the company's website afterward. Companies that plan to hold their next annual shareholder meeting virtually should review the Report to consider whether to implement any of the recommended practices for their 2021 VSM.

SIDLEY RESOURCES

Securities and Shareholder Litigation

Sidley recently launched Enhanced Scrutiny: The Sidley M&A and Corporate Governance Litigation Blog to provide timely updates and thoughtful analysis on M&A and corporate governance matters from the Delaware courts and, on occasion, other jurisdictions. You can submit your name and email address on the blog landing page to receive an email alert when a new blog entry is posted.

Corporate Governance

An article titled Board Considerations for an Uncertain 2021 by Holly J. Gregory, a partner in Sidley's New York office, was published in the December 2020/January 2021 edition of Practical Law's *The Governance Counselor*. The article explores the issues public company boards will face in 2021, including risks and trends that have emerged in light of heightened economic turmoil, social unrest, and the COVID-19 pandemic.

Shareholder Activism

An article titled The Comeback of Hostile Takeovers by Kai H.E. Liekefett, a partner in Sidley's New York office, was published in the 2020 Autumn Edition of *Ethical Boardroom*. The article discusses the resurgence of hostile takeovers and provides seven steps companies can take to prepare for a hostile takeover bid.

ESG

An article titled The Black Lives Matter Movement's Implications for Shareholder Derivative Litigation by Kristen Seeger, Alexa Perez and Nilofer Umar, lawyers in the Securities and Shareholder Litigation practice in Sidley's Chicago office, was published by *The AmLaw Litigation Daily* on October 28. The article discusses how lawsuits driven by social justice movements can create not only meaningful litigation costs but also crisis management issues stemming from increased public attention and media coverage.

An article titled Statutory and Voluntary Programs and Regimes in the United States Focusing on the E in ESG by Maureen M. Crough, counsel in Sidley's New York office, and Samina M. Bharmal, an associate in Sidley's Washington, D.C. office, was published in the *Oil and Gas Energy Law Journal* on October 22.

SEC/Regulatory

SEC Adopts Amendments to MD&A and Other Financial Disclosure Requirements (Nov. 23, 2020). On November 19, the SEC adopted amendments to streamline and enhance certain financial disclosure requirements in Regulation S-K. The changes to the Management's Discussion & Analysis of Financial Condition and Results of Operations (MD&A) disclosures in Item 303 emphasize the principles-based approach the SEC has favored recently and eliminate several more prescriptive requirements. This Sidley Update summarizes the most significant amendments, which companies should consider when preparing their upcoming Form 10-K filings.

SEC Division of Enforcement Annual Report Reveals Clear Contrast (Nov. 10, 2020). On November 2, the SEC's Division of Enforcement released its annual report providing a detailed overview of the SEC's enforcement efforts and accomplishments for the fiscal year ended September 30, 2020. In a trying and unusual year dominated by the COVID-19 pandemic, this report reveals a clear contrast between 2019 and 2020. The SEC brought far fewer actions than last year, but the financial remedies assessed and whistleblower awards reached new highs.

SEC Adopts Amendments to Whistleblower Program (Nov. 3, 2020). On September 23, the SEC voted 3-2 to adopt amendments to its whistleblower program. They are intended to provide enhanced clarity to whistleblowers, improve the program's efficiency and transparency, and likely increase the award dollar amount in a significant percentage of whistleblower actions. Companies should continually review their compliance programs and culture to ensure that potential whistleblowers feel comfortable reporting complaints internally without fear of retaliation.

Sidley lawyers authored the U.S. and EU chapters of the 17th edition of The International Comparative Legal Guide to: Merger Control 2021, a guide which provides corporate counsel and international practitioners with comprehensive legal analysis of the merger control laws and regulations in over 35 jurisdictions. Jim Lowe and Elizabeth Chen in Sidley's Washington, D.C. office authored the U.S. chapter and Steve Spinks and Ken Daly in Sidley's Brussels office authored the EU chapter.

Executive Compensation

Higher Taxes Potentially Ahead for Executive Compensation: President-Elect Biden's Proposed Tax Plan's Effects on Executive Pay (Nov. 9, 2020). With the Democratic Party having won the presidency and retaining control of the House of Representatives, the stage is set for President-elect Joe Biden's policies and priorities to be reflected in the upcoming legislative agenda. This may include Biden's plans to increase federal income taxes and Social Security taxes on high earners, which affects executive compensation. Employers may wish to take certain actions with respect to their executive compensation programs to mitigate the effects of the tax increases.

SIDLEY EVENTS

Public Company Issues in the COVID Era

December 16, 2020 | Webinar

Partners from Sidley's Corporate Governance, Shareholder Activism, and Securities Enforcement and Regulatory practices recently discussed the latest topics that should concern all public companies navigating the COVID-19 crisis. Click here to view the recording.

Hostile Takeovers and Shareholder Activism in a COVID-19 World

January 11, 2021 | Webinar

Sidley will host a webinar titled *Hostile Takeovers and Shareholder Activism in a COVID-19 World* on January 11. Partners Kai Liekefett and Derek Zaba will discuss the evolution of hostile M&A and shareholder activism in the COVID era, what to expect in the 2021 proxy season, and how to stay on the front foot in the current environment. Anyone interested in attending should contact nyevents@sidley.com.

SIDLEY SPEAKERS

Capital Markets for Reporting Companies

January 25-27 | Virtual

The Northwestern University Pritzker School of Law is sponsoring the 48th Annual Securities Regulation Virtual Institute January 25-27. Samir Gandhi, a partner in our New York office, will participate in a panel titled *Capital Markets for Reporting Companies* on January 25. Click here for more information.

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