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SIDLEY

ANALYSIS

INTERLOCKING DIRECTORATE CONSIDERATIONS IN M&A AND PROXY CONTESTS

By Karen Kazmerzak and Jim Lowe[1]

The U.S. economy's recovery has led to increased deal flow for mergers, acquisitions, minority and co-investments, and SPACs. With these transactions, as with shareholder activism, board seats are often in play, which brings the potential for board interlocks that may create antitrust issues. This article offers a refresher on the antitrust considerations for evaluating the suitability of director appointments.

Interlocking directorate issues may arise when a person serves as an officer or director of two competing companies. In a proxy contest, activist investors should ensure that their candidates do not have any interlocking directorate issues, like in the recent proxy contest launched by activist investor Ancora Holdings, Inc. against Blucora, Inc. *Press Release*, Blucora, Inc., "*Acclaimed Antitrust Expert Believes Ancora CEO Fred DiSanto Cannot Serve on Blucora's Board of Directors*" (Apr. 12, 2021).[2] The issue can also arise in connection with deals cleared by the U.S. antitrust agencies. *Press Release*, Dep't of Justice, "*Tullett Prebon and ICAP Restructure Transaction after Justice Department Expresses Concerns about Interlocking Directorates*" (July 14, 2016) (allowing partial investment between parties under Section 7 of the Clayton Antitrust Act, but requiring the parties to remove director interlock). Most recently, two executives stepped down from a board after the Department of Justice (DOJ) expressed concerns that the appointments created an illegal director interlock between two companies that compete in ticket sales in sports and entertainment markets. *Press Release*, Dep't of Justice, "*Endeavor Executives Resign from Live Nation Board of Directors after Justice Department Expresses Antitrust Concerns*" (June 21, 2021).

Section 8 of the Clayton Act is the primary antitrust enforcement mechanism limiting service of directors and officers on boards. 15 U.S.C. § 19. Two other statutes may also be enforced to prohibit or limit board interlocks. Section 1 of the Sherman Act, 15 U.S.C. § 1, prohibits director interlocks that unreasonably restrain trade, and Section 5 of the Federal Trade Commission (FTC) Act, 15 U.S.C. § 45, may prohibit a director interlock as an unfair method of competition. Even where an interlock does not constitute a technical violation of Section 8, it may raise issues under Sections 1 or 5 if the common director on the boards of competing corporations would have access to competitively sensitive information of either or both companies.

The interlocking directorate prohibition was enacted due to concerns that competitors could use boardroom activities to facilitate collusion.

Unlike Sections 1 and 5, a violation of Section 8 is a per se offense, meaning that if the conduct fits squarely within the statute, that conduct is unlawful. The result of finding a violation is that the interlock must be dissolved by the person creating the interlock leaving at least one of the boards. It is not possible to solve the Section 8 issue by recusing the interlocking director from meetings, decisions and other communications that relate to the competitive overlaps. The reason for this treatment goes back to the statute's origins. The interlocking directorate prohibition was enacted due to concerns that competitors could use boardroom activities to facilitate collusion. In 1914, the same year Section 8 was enacted, Louis Brandeis characterized director interlocks between competitors as "the root of many evils." Louis D. Brandeis, *Other People's Money and How the Bankers Use It*, 51 (1914).

Section 8 is a prophylactic measure meant to "nip in the bud incipient violations of the antitrust laws by removing the opportunity or temptation to such violations through interlocking directorates." *TRW, Inc. v. Fed. Trade Comm'n,* 647 F.2d at 946. In addition to

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2 Sidley represented Blucora, Inc. in its successful defense of the proxy contest launched by Ancora Holdings, Inc.

covering direct interlocks between competitors, it applies in cases where the interlock is at the board level and the competition occurs between the controlled subsidiaries instead of the parent companies. See, e.g., *In re BorgWarner Corp.*, 101 F.T.C. 863, 910 (1983), 102 F.T.C. 1164 (1983), *modified, rev'd sub nom., Borg-Warner Corp. v. FTC*, 746 F.2d 108 (2d Cir. 1984). It applies not only to individuals who sit on multiple boards but also to entities that have representatives on boards of competing companies. So if Entity A has a representative on the board of Company X and a different representative on the board of Company Y—a competitor of X—Section 8 would be violated if the jurisdictional thresholds are met.

Jurisdictional thresholds. Section 8 only prohibits director interlocks between companies that exceed the jurisdictional thresholds, have competitive sales above a *de minimis* level and have business activities with or within the United States. For 2021, the net worth (assets exceeding liabilities) threshold is $37,382,000 and the gross revenue threshold is $3,738,200. Even if the two companies exceed these thresholds, Section 8 would not apply if (1) the competitive sales of either company are less than $3,783,200 (2021 threshold), (2) the competitive sales of either company are less than 2% of that company's total sales or (3) the competitive sales of each company are less than 4% of that company's total sales.

Courts and the agencies have taken a broad view of what constitutes competition for purposes of Section 8.

Competition is defined broadly. Section 8 prohibits interlocks between companies that are "competitors, so that the elimination of competition between them would constitute a violation of the provisions of *any* of the antitrust laws." Clayton § 8, 15 U.S.C. § 19 (a)(1)(B) (emphasis added). Courts construe the statute broadly to prohibit interlocks between "ostensible competitors" on the basis that "the statute reflects a public interest in preventing directors from serving in positions which involve either a potential conflict of interest or a potential frustration of competition." *Protectoseal Co. v. Barancik*, 484 F.2d 585, 589 (7th Cir. 1973) (Stevens, J.). It applies equally to low levels of competition as it does to those affecting larger segments of commerce.

Courts and the agencies have taken a broad view of what constitutes competition for purposes of Section 8. Companies are considered competitors if they (1) are recognized by the industry as competing, (2) serve a similar function and (3) serve a common market. See *TRW, Inc. v. Fed. Trade Comm'n*, 647 F.2d 942, 947 (9th Cir. 1981). Courts and the FTC have found that a board interlock violated Section 8 even where customers may not be aware of the offerings of both parties, only one of the companies is able to meet a customer's requirements and the amount of actual competition between the two parties is *de minimis*. *Id.*; *see also* 1984 FTC Advisory Opinion re proposed SCM/Bohemia interlock (finding potential interlock despite no known direct competition between the two companies for sales to the same customer and combined market share of less than 1%).

One-year grace period. Any officer or director who was eligible to serve at the time of his or her election or selection to serve in the position has a one-year grace period after an intervening event to resign from that position. Intervening events would include one of the corporations crossing over the net worth threshold, exceeding the *de minimis* competitive overlap thresholds or making an acquisition that results in the two companies becoming competitors. At the moment the intervening event occurs, the director can lawfully serve for one year.

Other antitrust considerations. Even if the interlocking directorate is not prohibited, other antitrust laws may require the officer or director to take steps to recuse himself or herself from participation in certain decisions and not access certain information provided to the board that is directly relevant to the competitive overlap.

- The FTC has applied Section 5 of the FTC Act (which broadly declares "unfair methods of competition…unlawful") to enforce the "spirit and policy" of Section 8 to reach interlocks that Section 8 may not prohibit, such as interlocks between entities that are not corporations.
- Interlocks may be deemed part of an unlawful conspiracy under Section 1 of the Sherman

Act. Accordingly, even where Section 8 of the Clayton Act does not prohibit an interlock — e.g., where a *de minimis* exception is available — appropriate safeguards (e.g., information firewalls or recusals) should be considered as a means of preventing impermissible communications between the firms involved.

Enforcement. Section 8 can be enforced through actions brought by the DOJ or the FTC. Private parties also may sue under Section 8. The principal remedy for a violation is elimination of the interlock and, possibly, prohibitions of future interlocks. Damages are theoretically available to private plaintiffs, but we know of no case where they were awarded.

Section 1 of the Sherman Act increases the risk of liability (including treble damages) to the company if the company receives nonpublic competitively sensitive information about its competitor through the board representation or the board pulls its competitive punches based on the interlock.

Mitigating antitrust risk when Section 8 does not apply. In cases where the interlock falls outside Section 8 coverage, companies would need to resolve the Section 1 and Section 5 issues. Such measures would require that the interlocked director be restricted from receiving competitively sensitive information that she could use in her role as a director on the other board. To the extent there is an overlap, such a protocol often includes the interlocked director's removal and recusal from meetings, decisions and other communications that relate to the competitive overlaps. The protocol also often would restrict the interlocked director from receiving any nonpublic competitively sensitive information about the competitive overlap unless it is in an aggregated form that does not state, identify or describe any competitively sensitive information.

COVID-19 VACCINATION PROGRAM CONSIDERATIONS FOR EMPLOYERS AND BOARDS

By Wendy M. Lazerson, Natalie C. Chan, Abigail Hudson and Emily P. Morgan[3]

The question of whether an employer may mandate a COVID-19 vaccine prior to obtaining full FDA approval remains an open issue.

With the COVID-19 vaccine now widely available in the United States, many employers are wondering whether they can and/or should require employees to be vaccinated as a condition of returning to work. The U.S. Equal Employment Opportunity Commission (EEOC) clarified in May 2021 that nothing in federal employment nondiscrimination laws prohibits an employer from mandating that employees physically entering the workplace be vaccinated for COVID-19, subject to reasonable accommodation provisions of certain employment laws. However, the EEOC also stated that it was deferring to the U.S. Department of Health and Human Services (HHS) Food and Drug Administration (FDA) with regard to its realm of jurisdiction — legal implications of emergency use authorization (EUA) or FDA approach to vaccines. The FDA's authorization of COVID-19 vaccines to date is limited to EUA. Therefore, the question of whether an employer may mandate a COVID-19 vaccine prior to obtaining full FDA approval remains an open issue. Notably, there is no precedent for mandating a COVID-19 vaccine with only EUA status other than a recent decision of a district court judge in Texas, whose decision was specific to Texas law and the broad latitude it provides to employers. That decision is on appeal. Moreover, some Americans remain reluctant to receive the vaccine at all, further complicating how employers and boards of directors may be thinking about this issue and the practical implications of mandating a vaccine if it could mean loss of a portion of a workforce that refuses to become vaccinated.

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EUA Status of the COVID-19 Vaccine

The COVID-19 vaccines available at this time are marketed under EUA — meaning they are not fully approved by the FDA but have been approved for use in an emergency after satisfying certain criteria. The EEOC highlighted in its guidance, updated in May 2021, that it lacks jurisdiction to discuss the relevance of the vaccines' current EUA status and points to the FDA's EUA guidance. The EUA guidance requires that the FDA "ensure that recipients of the vaccine under an EUA are informed, to the extent practicable under the applicable circumstances, that FDA has authorized the emergency use of the vaccine, of the known and potential benefits and risks, the extent to which such benefits and risks are unknown, that they have the option to accept or refuse the vaccine, and of any available alternatives to the product."

EUA status for a vaccine is relatively unprecedented — and mandating a vaccine with only EUA approval is even more so. In the early 2000s, the U.S. Department of Defense mandated that certain service members receive an anthrax vaccine that had not received full FDA approval for anthrax inhalation, but this policy was challenged by the service members and enjoined by a federal district court in *Doe v. Rumsfeld*, 341 F. Supp. 2d 1 (2004). The Department ultimately changed its policy to make the EUA anthrax vaccine voluntary.

Recently, some employees have brought legal challenges against employer-mandated EUA vaccines. On June 12, 2021, a federal district court in Texas issued an order dismissing such a lawsuit against a Houston hospital, reasoning that Texas employment laws did not prohibit an employer from terminating employees for refusing to be vaccinated, notwithstanding the EUA status of the vaccines. See *Bridges v. Houston Methodist Hospital*, No. 4:21-cv-01774 (U.S. District Court for the Southern District of Texas). The court reasoned that firing an employee for refusing to get the COVID-19 vaccine would not amount to a wrongful termination under Texas law. The court further concluded that mandating the vaccine would not violate the federal law requiring the Secretary of HHS to ensure that EUA product recipients are informed of "the option to accept or refuse administration of the product" because this provision "does not apply at all to private employers like the hospital in this case." The decision is being appealed to the Fifth Circuit.

A California court currently faces a similar issue with school teachers and employees arguing that the FDA provisions preempt the local school district's policy of mandating vaccines. See *California Educators for Medical Freedom et al. v. The Los Angeles Unified School District et al.*, No. 21-cv-02388 (C.D. Cal. March 17, 2021). A similar claim is also pending against Dona Ana County in New Mexico, where a detention center employee alleges he has been threatened with termination for refusing to receive the vaccine. See *Legarreta v. Macias*, No. 21-cv-00179-MV-GBW (D.N.M. February 28, 2021). It remains to be seen how such challenges will fare.

Under the ADA, Title VII, and other federal employment nondiscrimination laws, an employer may require employees to be vaccinated for COVID-19 as long as they provide reasonable accommodations for employees who do not get vaccinated because of a disability or sincerely held religious belief, practice or observance.

Current Federal Guidance Regarding the COVID-19 Vaccine

EEOC Guidance. In December 2020, the EEOC issued guidance regarding the interplay and impact of the Americans with Disabilities Act (ADA), Title VII of the Civil Rights Act, and the Genetic Information Nondiscrimination Act (GINA) on the administration of the COVID-19 vaccine. Nowhere in the December 2020 guidance did the EEOC state unequivocally that employers can mandate that their employees receive the vaccine.

In May 2021, the EEOC updated its December 2020 guidance to state that "[t]he federal EEO laws do not prevent an employer from requiring all employees physically entering the workplace to be vaccinated for COVID-19, subject to the reasonable accommodation provisions of Title VII and the ADA and other EEO considerations…." In other words, under the ADA, Title VII, and other federal employment nondiscrimination laws, an employer may require employees to be vaccinated for COVID-19 as long as they provide reasonable accommodations for employees who do not get vaccinated because of a disability or sincerely held religious belief, practice or observance. What remains unclear is the interplay between the EEOC's guidance and the FDA provision regarding EUA products. The EEOC specifically stated that the legal implications of the vaccine's EUA status or the FDA approach to vaccines were "beyond the EEOC's jurisdiction," and its guidance is limited to compliance with federal equal employment opportunity laws.

CDC Guidance. The U.S. Centers for Disease Control and Prevention (CDC) has issued general guidance, last updated on June 11, 2021, stating that everyone 12 years of age and older is now eligible to get a COVID-19 vaccine and encourages vaccination as a "safe and effective" tool to help stop the pandemic. Additionally, the CDC has issued guidance stating that fully vaccinated people may "[r]esume activities without wearing masks or physically distancing, except where required by federal, state, local, tribal, or territorial laws, rules and regulations, including local business and workplace guidance." Nevertheless, the CDC also explains that it is "still learning" how long the COVID-19 vaccines protect people and how effective the vaccines are against new variants of the virus, among other things. Moreover, the CDC has not yet addressed whether employers may mandate EUA vaccines.

OSHA Guidance. The Occupational Safety and Health Administration (OSHA) issued guidance, updated on June 10, 2021, reiterating that employers have a responsibility to provide a safe and healthy workplace free from recognized hazards likely to cause death or serious physical harm. OSHA has not yet stated outright whether employers can or should mandate the vaccine as part of their general duty to maintain a safe and hazard-free workplace. OSHA recommends that employers grant paid time off for their employees to get vaccinated. Furthermore, OSHA states that, with a few exceptions, "most employers no longer need to take steps to protect their fully vaccinated workers who are not otherwise at-risk from COVID-19 exposure."

What Does this Mean? In light of this background, and federal law requiring that individuals be informed of the option to refuse an unapproved product under EUA status, mandating the current COVID-19 vaccines could pose legal and/or reputational risks — notwithstanding the updated EEOC guidance that federal discrimination laws do not prevent a mandate. Certain vaccine providers have begun the process of obtaining full FDA approval. Employers should monitor this process, given that FDA-approval status will affect legal and practical considerations.

State and Local Law Considerations

State agencies and legislatures are implementing orders and guidance regarding vaccination and considering a variety of contradictory measures that will affect workplace vaccination policies even after the vaccines receive FDA approval.

In addition to considering federal guidance and other authority, employers must review and comply with applicable state and local laws that could apply to employer-mandated vaccination programs. To date, many states are considering (and some have adopted) legislation that addresses whether employers can require a COVID-19 vaccine. Some state guidance (e.g., California) applies only to FDA-approved vaccines and is silent on EUA vaccines. Several other states have pending or passed legislation banning "vaccine passports" and prohibiting businesses from requiring customers or employees to show proof of vaccination.

Separate from the discussion around mandating the vaccine, several states and localities have also issued orders and guidance that loosen restrictions for fully vaccinated individuals. Lifting such restrictions could significantly affect the bottom line for businesses, as having fully vaccinated employees generally would mean, subject to applicable law, less time such employees need to be away from work due to illness or mandatory quarantine. Even more, some states have issued authority on how to maintain information regarding vaccination — such as proof of vaccination — and the fact that it must be stored separately as confidential medical information. Others have issued authority on eliciting vaccine status. Cal/OSHA in California has mandated that employers must ascertain the vaccine status of all employees if those employees seek to take their masks off in the workplace. Where an employee refuses to state their status, the employee will be considered unvaccinated. Yet in other states, employers are prohibited from inquiring. Employers, particularly those with multistate workforces, will have to monitor all of these state and local developments.

Encouraging Vaccination in Lieu of a Mandate

Many employers are considering (or are already implementing) the alternative of encouraging rather than requiring employees to be vaccinated, including by offering vaccination clinics onsite; allowing employees to get vaccinated during work hours; providing transportation to and from vaccine sites; appointing vaccine ambassadors; and creating a communications strategy. Other methods of encouraging vaccines implemented by employers include providing financial incentives such as extra paid time off, one-time cash bonuses and gift cards.

As employers return to work, they must consider federal, state and local developments relating to the vaccine. The analysis for each workforce will be context-specific and depends on workplace dynamics as well as applicable state and local law.

This approach has several advantages. First, from a practical standpoint, it is unlikely that employers want to terminate portions of their workforce who simply do not want to be vaccinated, particularly where the lack of a vaccine does not pose a direct threat to the workplace. Second, there is the administrative burden of evaluating the inevitable requests for disability and religious accommodations that will ensue as well as the risk of discrimination claims from those excluded from the workplace. Thus, encouraging and not requiring employee vaccination may help avoid the administrative burdens of tracking vaccines and the privacy considerations that accompany obtaining and storing personal medical information. In this vein, the EEOC's May 2021 guidance did confirm that employers generally may offer incentives to employees for receiving the COVID-19 vaccine or providing proof of vaccination. In the context of an employer-administered vaccine, the EEOC stated that any incentive cannot be "so substantial as to be coercive" but did not offer more guidance on what could be considered "coercive."

The Board's Role

While management bears the day-to-day responsibility for managing a corporation's COVID-19 vaccination program, the board of directors should play an important oversight role given the high stakes. The program implicates many areas of the business that are critical to the corporation's success, including employee health and safety, employee morale and retention, an inclusive corporate culture, and litigation and reputational risk management. Oversight of the program may be undertaken by the full board or handled by a board committee—most logically the committee tasked with overseeing human capital management matters. The board (or committee) should assess whether management is taking appropriate action with respect to the vaccination program—but also office reopening plans and workforce strategy more broadly—and provide guidance and direction to the extent the board determines is prudent. The board should also ensure that there is a robust, confidential system in place for employees to raise concerns and a firm policy against retaliating against an employee who refuses to be vaccinated. To be most effective, the board must stay well-informed of developments within the corporation as well as the rapidly changing situation externally.

COVID-19 as an epidemic continues to evolve, and, with this evolution, employers and boards must continue to consider their risk tolerance, the legal issues and the practical implications of their decisions.

BUSINESS AND POLITICS: WHEN SHOULD COMPANIES TAKE A PUBLIC POSITION?

By Thomas A. Cole[4]

Those of us who lived through the 1960s hear a loud echo of those turbulent times in the challenges of the current decade.

The '60s were a time of war and protests, assassinations, racial discrimination and the fight for civil rights and against environmental pollution. The decade began and ended with recessions. Many of our current challenges are, unfortunately, the same—with some new complexities, such as gun violence, the climate crisis and (of course) the pandemic. On top of that, social media and a far more polarized political discourse have heightened emotions and detracted from the quality of debate.

Another difference between the '60s and today is the greater prominence and power of corporations, with businesses now viewed as more competent and ethical than both governments and the media. Employees and consumers are paying more attention to corporations' policies and practices when deciding where to work and what to buy. And corporate social responsibility is broadly accepted as a legitimate pursuit of public companies, at least so long as there is a reasonable nexus to long-term shareholder value.

All of this raises several questions in the minds of those who think about corporate governance: What does this sea change mean for organizational leaders in terms of addressing social issues, particularly political ones? And what are the best practices for companies considering taking a stand?

Should organizations and their leaders generally take a public stand?

It is becoming somewhat expected for CEOs to issue personal statements or for their companies to issue statements and take action on social, environmental and political issues.

Given the factors described above, it is becoming something of an expectation for CEOs to issue personal statements or for their companies to issue statements and take action on social, environmental and political issues. For example, a stunning number of corporations, executives and others signed the "We Stand for Democracy" statement that appeared on April 14 as double full-page ads in *The New York Times* and *The Wall Street Journal*.

Taking positions on political issues has generated more pushback than position-taking by corporations on social or environmental issues. However, some argue that in an age when every subject is politicized (think of mask-wearing), it is hard to say what is not "political." Correspondingly, in these fraught times, silence is often construed as a statement. And then there are the more broad-brush assertions—that democracy is good for business and even necessary to preserve capitalism; thus, taking political positions that support democracy is good for corporations and their stakeholders.

There are also some assertions against taking a stand on political issues. "[A]nnouncements on purely political issues will alienate many...employees and customers," argued Harvey Golub, former American Express Co. chair and CEO, in a *Wall Street Journal* opinion piece. He also believes that there is "no limiting principle" when CEOs comment on issues unrelated to their businesses; when CEOs comment on one concern, they open the door to being called on to comment on all social concerns. And as Home Depot co-founder Ken Langone said in support of the company's cautious statement on voting rights, "If America is about as evenly divided as it appears it is, you're going to piss off one side or the other [of] your customers." (Interestingly, Arthur Blank, another Home Depot co-founder, was a signatory of "We Stand for Democracy.") It is notable that many who oppose CEO and corporate political speech do not seem to oppose corporate political contributions or CEOs publicly endorsing and raising funds for individual candidates for office.

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Board members should help CEOs understand that they should expect to have a discussion with, at least, the leadership of the board before either the CEO or the corporation takes a position on a controversial political issue.

How can boards and CEOs decide whether their organizations should speak out on specific issues?

Board members, CEOs and other company leaders may see key opportunities—or imperatives—to speak out on political and social issues in the coming months and beyond. Board members should help CEOs understand that they should expect to have a discussion with, at least, the leadership of the board before either the CEO or the corporation takes a position on a controversial political issue. That discussion might start with weighing the above arguments for and against taking a position and deciding which they find to be most compelling.

If the company or individual is still considering taking a position after this, the board and CEO might engage in a traditional corporate social responsibility analysis to reach a rational business judgment about whether taking a particular position is to the long-term benefit of shareholders. For controversial issues (political or otherwise), this means netting the costs of blowback against the benefits of speaking out.

Benefits can include positive reactions from important constituencies, such as employees and customers, and avoiding negative reactions that might result from silence. Speaking out responsibly can also burnish a corporation's general reputation. On the other hand, not all constituencies will have the same reactions, and the implications of that should be considered.

To help guide this decision, boards and CEOs would also benefit from a thoughtful consideration of the following questions:

- Is silence a real alternative? That is, will the CEO be asked for his or her view on an analyst call, in an employee town hall meeting or otherwise, and if so, is a "no comment" response viable?
- Can a statement be crafted to take a responsible position in a non-incendiary fashion? (This was the path taken by corporations arguing for voting rights without making a specific attack on the new Georgia voting-related legislation.)
- Is joining a statement by an ad hoc group of companies or a business organization (such as the Business Roundtable) a preferable and feasible alternative to having the company speak out alone?
- What are the plans for the release of the statement both internally and externally? So that the company may speak with one voice and do so effectively, have individuals been designated as the only people authorized to respond to questions and concerns, and are these individuals well prepared to do so?
- If the statement is critical of a specific piece of legislation or articulated governmental policy, does it fairly represent the substance of that legislation or policy?
- Is a statement, without additional action on the issue, going to be enough—or will it expose the company to assertions that it is "all talk"? Are there actions the company can take or existing efforts it can highlight in support of the issue?
- Does the proposed position align with the company's expressed values and culture?
- Are other actions by the company going to be viewed as inconsistent with the statement, exposing the company to being challenged as hypocritical?
- If it is determined that it is not in shareholders' long-term interests for the company to take a position, can the CEO nevertheless speak out personally?

Not every CEO or board will conclude that their corporation should take positions on controversial political issues or other social topics. For those that do, following good governance practices will help ensure that taking a position can be defended as an exercise in appropriate corporate social responsibility.

NEWS[5]

JUDICIAL DEVELOPMENTS

"Chalking Up a Victory for Deal Certainty," Delaware Court of Chancery Orders That Contested Merger Close

Snow Phipps is a must-read for those interested in the drafting and negotiation of M&A agreements generally and their operation during the COVID-19 pandemic specifically.

On April 30, then Vice Chancellor (now Chancellor) Kathaleen McCormick issued a decision in *Snow Phipps Group, LLC v. KCake Acquisition, Inc.* that ordered the defendant buyers to specifically perform their agreement to acquire DecoPac Holdings, Inc., which sells cake decorations and technology for use in supermarket bakeries. The 125-page decision, which the Delaware Court of Chancery rightly describes as a "victory for deal certainty," offers a detailed analysis of several common contractual provisions in the time of COVID-19.

The stock purchase agreement at issue was negotiated in early 2020, as the COVID-19 pandemic was unfolding. At least two key matters were discussed in the 48 hours before the agreement was signed on March 6, 2020. First, on March 4, buyers reduced their offer from $600 million to $550 million; sellers accepted, believing COVID-19's impact on the market and other potential buyers left only a failed process as the alternative. Second, that same day, the sellers sought to carve "pandemics" and "epidemics" out of the definition of a "Material Adverse Event" (MAE). The buyers refused, though buyers' counsel assuaged sellers' counsel that the other broad carveouts (e.g., for an economic downturn) would provide protection if caused by the COVID-19 pandemic.

The court found that, soon after signing the agreement, buyers "lost their appetite for the deal." On March 17, buyers held an internal meeting to broadly "discuss the impact of COVID-19." Later that day, a call was held with deal *and* litigation counsel to discuss "closing" on the transaction with reference to the presigning proposed edits to the MAE provision. Buyers then prepared a number of models, "all of which projected that the company's performance would decline precipitously." Once prepared, buyers *then* asked the company questions about its March 2020 performance, claiming the "lenders were asking" questions (a pretext that the court later found was false). In the meantime, the company was anticipating that despite its sales declining in the immediate wake of government shutdown orders, there soon would be "pent-up demand" because government orders might start to be lifted and the public would want to "celebrate life events amidst the pandemic." On March 26, the company circulated a reforecast, which was deemed "illogically optimistic" by buyers "seventeen minutes" after receipt. Buyers sent only their own, more pessimistic model to their committed lenders and sought changes to the debt commitment letter. The lenders promptly indicated that they would not reopen the agreement but remained willing to close on the basis of the agreed commitment letter.

On April 1, 2020, buyers told sellers that the debt financing was "no longer available," even though the lenders all remained willing to close on the original terms. Buyers then engaged a financial adviser to "conduct a market check and assess the availability of alternative debt financing." By April 3, buyers were informed that securing financing would involve "a high degree of execution uncertainty" and terms "materially less favorable" than those originally agreed. Buyers then informed sellers that they could not obtain financing, that they believed an MAE had occurred, and that their counsel were investigating other potential breaches of the agreement. On April 14, sellers commenced litigation to compel specific performance of the agreement, including closing in early May. A week later, buyers sent a letter purporting to terminate the transaction on two grounds: (1) that debt financing was unavailable and (2) that the company purportedly had breached "representations, warranties, and covenants," including the MAE and ordinary course covenant, which buyers alleged could not be cured.

5 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Sonia Gupta Barros, Stephen L. Cohen, Matthew J. Dolan, Claire H. Holland, John P. Kelsh, Charlotte K. Newell, Hille R. Sheppard, Sara M. von Althann and Scott A. Gregus (summer associate).

By this time (mid-April 2020), as the company had predicted, its outlook began to improve, with demand for supermarket cakes returning.

The Court's post-trial decision offers a detailed analysis of the parties' varied factual and legal allegations. But its conclusions as to certain common M&A agreement provisions stand out.

MAE. Buyers argued that the company's MAE representation became inaccurate because its "'performance fell off a cliff' in March 2020 as a result of the escalating COVID-19 pandemic," and thus it would be *reasonably expected* to constitute an MAE. This, therefore, was an argument based on a potential future event: Buyers did not argue that an MAE had already occurred but that it was likely to occur in the future.

As is common, the agreement defined an MAE to exclude a number of events, including changes arising from "changes in any Laws, rules, regulations…issued by any Governmental Entity," although only so long as the matter did not have a "materially disproportionate effect" on the company as compared to its industry. The court's review of these detailed provisions reminds that MAE clauses typically "allocat[e] general market or industry risk to the buyer, and company-specific risks to the seller."

Snow Phipps reminds deal participants that the burden to prove an MAE is significant and likely will require evidence of a "persistent and sustained" failure in the target company's business.

The court looked to precedent—specifically, the *IBP* and *Akorn* cases—as "benchmarks" when considering whether DecoPac's March 2020 decline was expected to "mature into" an MAE. In *IBP*, a 64% decrease in year-over-year first quarter earnings did not suffice, as a recovery was on the horizon in the second quarter. In *Akorn*, on the other hand—the only case in which the Court of Chancery has held that an MAE occurred—the seller's EBITDA fell 55% after the agreement was signed, that downturn continued for a year, and there was no indication of improvement on the horizon. This "sudden and sustained drop" was reasonably expected to be an MAE. The court analogized DecoPac's situation to that in *IBP*, finding that no MAE was likely to occur because the company's March 2020 drop in performance already had "rebounded in the two weeks immediately prior to termination and was projected to continue recovering through the following year" and was "not projected to face a 'sustained drop' in business performance." This reminds deal participants that the burden to prove an MAE is significant and likely will require evidence of a "persistent and sustained" failure in the target company's business.

Ordinary Course. Buyers also argued that sellers breached the ordinary course covenant by drawing debt on a revolver and implementing cost-cutting measures. The ordinary course covenant at issue required that the company operate "consistent with past custom and practice," and buyers bore the burden of proving that the company had not complied "in all material respects." Such provisions "help ensure that the business the buyer is paying for at closing is essentially the same as the one it decided to buy at signing."

Here again, the court looked to precedent for a benchmark: In *AB Stable*, the court found that an ordinary course provision was breached where the owner of 15 luxury hotels had closed two of them and "severely limited the operations of the other" 13. These "extensive" changes to the operating business satisfied the standard. Against this backdrop, the court found that DecoPac's draw from a revolver and cost-cutting measures failed the standard. These arguments also failed for procedural reasons. The ordinary course covenant was tied to a notice requirement that would give the company a chance to cure the issue. Buyers had not provided the requisite notice regarding the revolver draw and thus "lacked the authority to terminate" on that basis. Buyers' cost-cutting argument also failed because buyers had not "assert[ed] it timely in litigation"— that is, at any time before their pretrial brief.

Reasonable Best Efforts. Generally stated, "reasonable best efforts" and "commercially reasonable efforts" require a party to take "reasonable steps to solve problems and consummate" certain obligations. Buyers had agreed to do so in connection with obtaining debt financing, and the court thus considered whether their request to reopen negotiation of certain debt financing terms satisfied the standard. The court found that buyers' creation of pessimistic projections in March 2020 were to illustrate a covenant breach rather than "any genuine effort to forecast" the company's performance. Because buyers' postsigning efforts relied on this pessimistic model, the court found that they failed to use "reasonable best efforts."

Award of Specific Performance. The parties had contracted for the availability of specific performance as a remedy for breach *if* debt financing were funded. Buyers moved to dismiss on this basis, but the court denied the motion, finding that buyers could not "avoid specific performance" if the "prevention doctrine" applied. The prevention doctrine provides that when a party breaches "by nonperformance" and that nonperformance "contributes materially to the non-occurrence of a condition of one of his duties, the non-occurrence is excused." The court found that sellers had proven at trial that buyers' breaches "contributed materially" to the failure to obtain debt financing and thus that this requirement was excused.

The Pattern Energy *decision is a reminder to directors and their advisers that without careful adherence to an independent sales process and transaction structure, directors risk losing the liability protections that Delaware law otherwise provides.*

Delaware Court of Chancery Denies *Corwin* Cleansing in Light of Sales Process Concerns

In May, Vice Chancellor Morgan Zurn issued a significant, 200+ page decision on a motion to dismiss filed by defendants in the ongoing Pattern Energy transaction litigation, captioned *In re Pattern Energy Group Inc. Stockholders Litigation*, C.A. No. 2020-0357-MTZ. As we previously reported, class actions had been filed in the Delaware Court of Chancery and Delaware Federal District Court following the $6.1 billion going-private sale of Pattern Energy Group, Inc. to Canada Pension Plan Investment Board. Both cases present overlapping breach of fiduciary duty claims. The Court of Chancery has issued a decision denying defendants' motion to dismiss. The decision is a reminder to directors and their advisers that without careful adherence to an independent sales process and transaction structure, directors risk losing the liability protections that Delaware law otherwise provides.

Pattern Energy was formed nine years ago by Riverstone Pattern Energy Holdings, L.P., a private equity fund, for the purpose of operating renewable energy facilities developed by another Riverstone affiliate. Riverstone is not a Pattern Energy stockholder. Instead, plaintiffs alleged that Riverstone exercised control through Pattern Energy's primary upstream supplier of energy projects (Supplier), which provided most of Pattern Energy's business. Pattern Energy was itself a limited partner in Supplier, and Riverstone controlled Supplier. Importantly, the applicable partnership agreement prohibited Pattern Energy from selling its stake in Supplier without Supplier's consent, although a transaction could potentially be structured to avoid triggering this consent right. This effectively gave Riverstone (through Supplier) a veto right on a sale of Pattern Energy's stake in Supplier.

In addition to the tangled corporate structure, Riverstone was also alleged to have exercised control over Pattern Energy through various overlapping fiduciaries that served as Pattern Energy officers and directors. Pattern Energy's CEO, CFO, and president all had longstanding relationships with Riverstone and Supplier. In addition, two members of Pattern Energy's seven-member board had been appointed by Riverstone, including Michael Garland, who was also the company's CEO since its founding in 2012 and Supplier's president. However, there were no allegations that any of the other five members of the board were conflicted.

In 2018, the board decided to engage in a sales process and formed a special committee of the five disinterested directors to conduct that process (the Committee). The Committee, however, allegedly delegated primary responsibility for engaging potential bidders to Garland and also permitted the other conflicted director to attend Committee meetings as Riverstone's representative, including executive sessions. The Committee initially developed an offer from Brookfield Asset Management, Inc., which submitted a term sheet in March 2019 that structured a deal to avoid triggering Supplier's consent right. In April 2019 and without the Committee's knowledge or approval, Garland attended a meeting between

Riverstone and Canada Pension, a pension fund that had previously invested over $700 million in Riverstone funds. At the next Committee meeting, Garland suggested Canada Pension as a potential bidder without disclosing the Riverstone-Canada Pension meeting.

As the Committee continued its work, it received advice from Garland and Pattern Energy's chief legal officer (who was also an officer of Supplier) that because of the Supplier consent right, any potential merger would require Riverstone's agreement. This was not correct. The Committee also instructed bidders that it preferred a transaction that included the purchase of Supplier, meaning Pattern Energy's stockholders would have to split the transaction consideration with Supplier.

Brookfield and Canada Pension submitted final offers in October 2019. Brookfield proposed a stock-only transaction that offered Pattern Energy stockholders a 45% premium but was not predicated on a transaction involving Supplier. Canada Pension made an all-cash offer at a 14.8% premium and included an offer to buy Supplier at 1.8 times the amount of Riverstone's invested capital. Unlike Brookfield's proposal, Canada Pension's offer would allow Riverstone to maintain equity in Supplier, and Pattern Energy's and Supplier's management would remain in place. In response to Brookfield's offer, the Committee insisted that it include an agreement with Riverstone regarding Supplier. As a consequence, Brookfield withdrew its offer, and the board approved a transaction with Canada Pension.

The board delegated all authority to the company's officers to draft the merger proxy statement and did not review the proxy statement or supplemental disclosures before they were disseminated. 52% of Pattern Energy stockholders voted in favor of the merger. Crucially, 10.4% of those shares were voted by CBRE Caledon Capital Management Inc. The CBRE shares had been issued a year earlier in a private placement, and under the applicable terms, CBRE was required to vote in favor of any future merger recommended by the board.

In denying defendants' motion to dismiss, the Court of Chancery rejected arguments that liability was exculpated by Pattern Energy's charter because of sufficient allegations of bad faith and rejected the argument that the merger vote "cleansed" the transaction under *Corwin v. KKR Financial Holdings, LLC*.

Although the Special Committee established guidelines for the conduct of conflicted management, those guidelines were ignored, and even after the Committee learned that the guidelines had been ignored, it continued to delegate authority to conflicted management during both the sales process and the proxy drafting process, thus allowing conflicts to infect the Committee's process.

The court's rejection of exculpation is significant because, at least at the surface level, Pattern Energy ran a standard, independent sales process. Many of the usual approaches, including creation of an indisputably independent Committee, were employed here. However, the manner in which the Committee operated was deemed problematic. Although the Committee established guidelines for the conduct of conflicted management, those guidelines were ignored, and even after the Committee learned that the guidelines had been ignored, it continued to delegate authority to conflicted management during both the sales process and the proxy statement drafting process, thus allowing conflicts to infect the Committee's process. The problem of improper delegation and involvement by conflicted individuals was reinforced by the Committee's own insistence on deal terms that were favorable to Riverstone, particularly with regard to the treatment of Supplier, and the decision to proceed with a transaction with Canada Pension despite the Committee's own conclusion that the Brookfield offer was superior. Taken together, plaintiffs' allegations of bad faith persuaded the court that the existence of the otherwise independent Committee was not enough for the directors to invoke exculpation. The court also noted that plaintiffs' allegations of the directors' bad faith fit within a "paradigmatic *Revlon* theory" and that when such allegations are made, "they will generally be sufficient to support a nonexculpated claim at the motion to dismiss phase."

Importantly, the allegations of a flawed sales process were set against compelling allegations that Riverstone was acting as a controller, and that Riverstone—together with Supplier and conflicted officers and directors—formed a control group. While the court noted that it is an "open question" of Delaware law as to whether the soft power of entities alone are sufficient to support a finding of control, the court here, based on plaintiffs' allegations, approved of such a finding. In particular, the court credited plaintiffs' allegations about Riverstone's history with Pattern Energy, the relevance of Supplier's consent right, the existence of overlapping fiduciaries, and the involvement and influence of those fiduciaries in the sales process. The decision is an important reminder that control need not only be in the form of voting power, as Riverstone and Supplier had no such power, and that care must be given to any role played by interested entities and individuals in the sales process.

Finally, the court rejected defendants' arguments that the disclosures made to stockholders together with the vote of the disinterested minority of stockholders was sufficient to cleanse the transaction. Once the board authorized the transaction, it delegated to the company's officers the responsibility to draft and disseminate the merger proxy statement, just as most companies do. But here the delegation went too far and constituted an "abdication." The court found the extent of delegation improper because the board did not even retain for itself authority to review and approve the final disclosures. This resulted in certain alleged false and misleading disclosures. While delegation is not itself impermissible, this decision is a good reminder that care must be taken in both the extent of delegation and to whom delegation is made. The board cannot leave the responsibility of disclosure entirely to conflicted officers, and in no event should a board and its advisers absolve themselves of reviewing proxy statement disclosures before they are made.

The court further found that defendants' arguments for cleansing of the transaction (and application of the business judgment rule) under *Corwin* would be improper because there was no vote in favor of the transaction by a fully informed, disinterested minority of stockholders. To achieve the requisite vote total of the non-interested minority, the votes of CBRE (roughly 10% of the total) had to be included in the count. But CBRE's vote was dictated by the terms of a contract executed more than a year prior. By definition it was not "fully informed" and was coerced by punitive contractual penalties should CBRE have voted contrary to the board's recommendation.

CORPORATE GOVERNANCE DEVELOPMENTS

Ninth Circuit Reversal Revives a Constitutional Challenge to California's Board Gender Diversity Law

The California Legislature enacted a law (Senate Bill 826) in September 2018 requiring California-based public corporations to have at least one female director by the end of 2019, and, depending on board size, up to three female directors by the end of 2021. The California Secretary of State may impose a fine of $100,000 for a first violation of the law and $300,000 for any subsequent violation. The law is summarized in more detail in our Sidley Update available here.

In November 2019, Creighton Meland, a shareholder of OSI Systems, Inc., a California-based Delaware corporation, filed a lawsuit in the U.S. District Court for the Eastern District of California challenging the constitutionality of Senate Bill 826. Meland argued that the law violates the Equal Protection Clause of the Fourteenth Amendment by forcing or encouraging shareholders to discriminate on the basis of sex when voting for directors at a corporation's annual shareholder meeting. The district court dismissed the lawsuit in April 2020 on the basis that Meland lacked standing. The district court held that Meland's alleged injury was "purely hypothetical" and "neither real nor immediate" because (1) only OSI – and not Meland personally – could face monetary penalties, (2) the law did not prevent him from voting for a male director and (3) OCI is currently in compliance with the minimum threshold. Meland appealed the decision to the U.S. Court of Appeals for the Ninth Circuit.

On June 21, 2021, a Ninth Circuit panel reversed the district court's decision. The panel held that Meland plausibly alleged that the law requires or encourages him to discriminate based

Ninth Circuit in Meland v. Weber*: "In short, 'it strikes us as odd that' the California Legislature enacted coercive legislation to achieve gender parity, 'but at the same time it is asserting that these rules are not meant to change [any shareholder's] immediate behavior enough to confer standing to challenge' the law."*

on sex when voting in a director election. Relying on Ninth Circuit precedent, the panel determined that "a person required or encouraged to discriminate on the basis of a protected class…has suffered a direct personal injury sufficient to confer standing" to challenge the requirement. The panel considered the purpose and practical effect of the law. It determined that the California Legislature must have intended to require – or at least encourage – shareholders to vote for female directors. Failure to do so could expose the corporation to the risk of violating state law, monetary penalties and/or alleged "public shaming" (because the California Secretary of State annually publishes a list of noncompliant corporations). Therefore, as a shareholder of OSI, Meland is subject to the law's "coercive effect." The panel found that he sufficiently alleged an "injury in fact" and thus has standing to challenge the constitutionality of the law.

Finally, the panel rejected the state of California's argument that the case is unripe and moot because OSI is currently in compliance with the minimum threshold. Instead, the panel held that Meland's injury is ongoing (because shareholders must elect directors annually) and not merely hypothetical, and a district court ruling in his favor could grant him effective relief.

Despite this development, public companies headquartered in California with fewer than three female directors should prepare for compliance with the law by seeking out qualified female director candidates and considering whether to expand the size of their boards. They should take into account what approvals may be required (e.g., charter or bylaw amendments to increase the maximum size of the board, the timing of any board changes in relation to any upcoming annual meeting) and the related timing implications.

Momentum Continues to Build for Mandatory ESG Disclosures

In a recent speech, SEC Commissioner Allison Herren Lee noted that "boards increasingly have oversight obligations related to climate and ESG risks—identification, assessment, decision-making, and disclosure of such risks." She suggested that boards enhance the diversity and ESG competency of their boards and tie executive compensation to ESG metrics.

In his opening remarks at a financial market regulation conference in May and in several statements since, SEC Chair Gary Gensler has made clear that rulemaking activity focused on enhanced human capital and climate risk disclosure requirements will be a top priority for the SEC. Chair Gensler has argued that the SEC needs to develop new disclosure rules in order to meet investors' increasing desire for "consistent, comparable, decision-useful information."

According to Chair Gensler, new disclosure requirements could require public companies to disclose additional human capital metrics, such as workforce turnover, training, compensation and benefits, diversity and health and safety. This would represent an expansion of the human capital disclosure rules adopted under previous SEC Chair Jay Clayton in August 2020, which require companies to provide a description of their human capital resources and any human capital measures or objectives a company focuses on in managing the business to the extent material to an understanding of the business as a whole. Previously companies were required to disclose only their total number of employees, a requirement that the August 2020 rules retained.

Support is also steadily rising for the SEC to mandate that public companies disclose their environmental impact or vulnerability to climate risks. In May, President Joe Biden signed an Executive Order on Climate-Related Financial Risk signaling that addressing climate change is a high priority for the current administration and providing further support for the SEC's ongoing efforts in this area.

As discussed in our last issue of *Sidley Perspectives*, in March 2021 the SEC invited public comment on potential climate-related disclosure requirements to assist the SEC as it considers rule amendments. The SEC received more than 400 unique comment letters before the June 13 deadline, including a letter from a coalition of 12 Democratic state attorneys general asking the SEC to require public companies to disclose details about the impacts of climate change on their businesses and their related risk management strategies.

A group of 16 Republican state attorneys general responded by submitting a letter urging the SEC not to mandate additional climate change disclosures.

Chair Gensler has asked the staff to propose recommendations for the SEC's consideration on mandatory climate risk disclosure requirements and to identify which metrics (e.g., greenhouse gas emissions) are most useful to investors. He also directed the staff to consider whether the SEC should impose requirements on public companies that have made forward-looking climate commitments or that are subject to specific climate-related targets in other jurisdictions.

On June 16, the House of Representatives passed the ESG Disclosure Simplification Act of 2021, which would require public companies to annually disclose in their SEC filings certain environmental, social and governance (ESG) metrics and their relation to the company's long-term business strategy. If enacted, the bill would also require new disclosures about specified topics including political spending, executive compensation, climate risk, tax havens and offshoring, board diversity, workforce matters and cybersecurity. The bill passed in the House by a very narrow margin—a 215-214 vote—and it faces an uncertain future in the Senate as it is likely to draw strong opposition from Republican lawmakers.

Given the heightened focus from the SEC, Congress and investors and new disclosure requirements expected to be proposed later this year, public companies should continually consider how they might enhance their disclosures regarding human capital metrics and climate risks.

The recent push by the SEC and Congress to accelerate rulemaking activity on human capital and climate risk disclosures has drawn criticism. Opponents argue that mandating disclosures for environmental and human capital issues imposes unnecessary cost and reputational harm on public companies. These critics also claim that current SEC rules requiring the disclosure of material risks are sufficient to address investors' concerns about human capital and environmental issues. However, in a May speech, SEC Commissioner Allison Herren Lee argued that is a "myth" and that "[t]he securities laws currently include little in the way of explicit climate or other sustainability disclosure requirements."

The SEC released its latest rulemaking agenda on June 11, indicating plans to propose enhanced disclosure requirements with respect to corporate board diversity, human capital management and climate change risks by October. Given the heightened focus from the SEC, Congress and investors and new disclosure requirements expected to be proposed later this year, public companies should continually consider how they might enhance their disclosures regarding human capital metrics and climate risks.

SEC DEVELOPMENTS

SEC Staff Will Not Enforce Trump-Era Proxy Voting Advice Guidance and Rules While It Considers Further Action

There has been a debate for more than a decade about the appropriate regulatory response to the role—and arguably outsized influence—of proxy advisors such as ISS and Glass Lewis. In August 2019, the SEC under the Trump Administration published a new interpretation and related guidance regarding the applicability of the federal proxy rules to proxy voting advice furnished by proxy advisors. The guidance confirmed that (1) proxy voting advice provided by a proxy advisor generally constitutes a "solicitation" (as defined in Exchange Act Rule 14a-1) under the federal proxy rules and (2) the anti-fraud provisions in Exchange Act Rule 14a-9 apply to proxy voting advice. See the Sidley Update available here for more details. In October 2019, ISS filed a lawsuit in the U.S. District Court for the District of Columbia challenging the 2019 interpretation and guidance.

In July 2020, the SEC adopted rule amendments to (1) codify its view that proxy voting advice generally constitutes a "solicitation" subject to the federal proxy rules and (2) clarify that the omission of certain information from proxy voting advice may, depending on the particular facts and circumstances, violate the anti-fraud provisions. The SEC also adopted controversial amendments that would impose additional disclosure and procedural requirements on proxy advisors as conditions for being able to continue relying on exemptions from the information and filing requirements of the federal proxy rules. New Exchange Act Rule 14a-2(b)(9) would make a proxy advisor's reliance on the exemptions contingent on the proxy advisor (1) providing clients with enhanced disclosures about conflicts of interest and (2) adopting and publicly disclosing written policies and procedures reasonably designed to ensure that companies have an opportunity to review and respond to the proxy voting advice in advance of the shareholder meeting. The rule amendments took effect on November 2, 2020, and proxy advisors must comply with the new conditions by December 1, 2021. See the Sidley Update available here for more details.

On June 1, 2021, SEC Chair Gary Gensler issued a statement directing the SEC staff to consider whether to recommend further regulatory action regarding proxy voting advice. Specifically he asked them to consider whether to recommend that the SEC "revisit" (1) its 2020 codification of the definition of "solicitation" as encompassing proxy voting advice, (2) the 2019 interpretation and guidance regarding the definition of "solicitation" and (3) the conditions on exemptions from the information and filing requirements in the 2020 rule amendments.

In light of this directive, the SEC's Division of Corporation Finance (Corp Fin) announced later that day that it is considering whether to recommend that the SEC revisit the 2019 interpretation and guidance and the 2020 rule amendments. While the SEC considers further regulatory action, Corp Fin will not recommend enforcement action to the SEC based on the 2019 interpretation and guidance or the 2020 rule amendments. If any future SEC action retains the 2020 exemption conditions with a December 1, 2021 compliance deadline, the staff "will not recommend any enforcement action based on those conditions for a reasonable period of time" after any decision by ISS to revive its lawsuit, which the SEC and ISS agreed to suspend while the SEC explores potential changes to the rules that could render ISS's claims moot.

Given the increasingly political nature of the SEC these days, it may become more common for a single SEC Commissioner or division to attempt to amend or undo rules that were properly adopted by the SEC under a previous administration.

SEC Commissioners Hester Peirce and Elad Roisman issued a joint statement objecting to the SEC's reversal on a properly adopted rulemaking that had received significant input from relevant stakeholders.

While proxy advisors may take comfort in the SEC's no-action position, it is an unfortunate development for companies because the rule amendments were designed to increase transparency. The SEC released its updated regulatory agenda on June 11 indicating that Corp Fin is considering recommending that the SEC propose rule amendments governing proxy voting advice by April 2022.

SEC Enhances Focus on Rule 10b5-1 Plans—What Should Companies Do Now?

On June 7, SEC Chair Gary Gensler expressed concern about potential abuses of Securities Exchange Act Rule 10b5-1 and announced that he expects to revise the rule. The SEC followed with an updated regulatory agenda signaling that proposed new rules may come before the end of the year.

Rule 10b5-1 provides an affirmative defense from insider trading for corporate insiders and companies to buy and sell company stock as long as they adopt their trading plans in good faith and while not in possession of material nonpublic information. These arrangements typically involve periodic sales pursuant to a schedule determined at the outset of the plan, sometimes combined with giving a third party (generally a broker) sole discretionary authority with respect to certain aspects of the trades. However, academic studies have asserted that some executives use 10b5-1 plans to engage in opportunistic, large-scale selling of company shares. There are limited SEC enforcement actions concerning Rule 10b5-1 and none recent.

Concerns about potential abuses of Rule 10b5-1 trading plans are not new. Last year, then-SEC Chair Jay Clayton raised questions about the use of 10b5-1 plans when those plans overlap with company share repurchases and recommended a mandatory waiting period after adoption, amendment or termination of a 10b5-1 plan. In 2019, the U.S. House of Representatives introduced bipartisan legislation that would have required the SEC to explore and possibly implement amendments to 10b5-1. Additionally, publications such as *The Wall Street Journal* have expressed concerns over the years, citing specific circumstances of alleged abuse, such as directors using 10b5-1 plans to sell their shares heavily in a short period of time.[6]

Chair Gensler listed five areas he has asked the SEC staff to consider for potential reforms:

- ***Cooling-Off Period:*** Chair Gensler recommended a cooling-off period when insiders or companies adopt 10b5-1 plans before they can make an initial trade. He noted, with approval, that proposals of four to six months have received support from former Chair Clayton and current Commissioners Caroline Crenshaw and Allison Herren Lee. We note that while cooling-off periods are in our experience common, they are typically much shorter than four to six months.
- ***Limitations on Cancellation of 10b5-1 Plans:*** Chair Gensler has asked the staff to consider limitations on when and how plans can be cancelled because currently there is no regulatory prohibition on canceling a 10b5-1 plan when in possession of material nonpublic information.
- ***Mandatory Disclosure Requirements:*** There are no disclosure requirements for 10b5-1 plans, and Chair Gensler recommends disclosure for the adoption, modification, and terms of Rule 10b5-1 plans.
- ***Absence of Limits on Number of 10b5-1 Plans:*** Insiders can currently enter into multiple plans, permitting insiders to cancel, amend, or choose the most favorable plan to rely on for sales.
- ***Share Buybacks:*** Chair Gensler has asked the staff to consider reforms that address the relationship between 10b5-1 plans and corporate share buybacks.

Some of these recommendations are already considered best practices for those adopting a 10b5-1 plan. Chair Gensler's comments signal the likelihood of a near-term rulemaking proposal or request for public comment and increased scrutiny of trading and policies related to 10b5-1 plans. In particular, Chair Gensler noted that when insiders cancel and amend plans, this raises the question of whether the plan was entered into in good faith. Companies should prepare by reviewing their policies and practices related to the use of 10b5-1 plans to protect the company and its insiders should the SEC investigate. We note that the SEC Enforcement Division's increased use of data analytics could be used to identify anomalous executive trading, including pursuant to 10b5-1 plans.

Chair Gensler's comments signal the likelihood of a near-term rulemaking proposal or request for public comment and increased scrutiny of trading and policies related to 10b5-1 plans.

SEC Reopens Comment Period for Universal Proxy; Sidley Submits Comment Letter Recommending Limitations on "Proxy Access on Steroids"

In April, the SEC reopened the comment period on the rule amendments proposed in 2016 for the use of universal proxy cards in all non-exempt solicitations for contested director elections. The release requested data and comments generally in light of regulatory and market developments since the rules were proposed and identified 25 specific topics on which the SEC welcomed input.

On June 7, the leaders of Sidley's Shareholder Activism & Corporate Defense Group submitted a formal 20-page comment letter to the SEC (summarized in a Sidley Update

6 See Susan Pulliam and Rob Barry, Directors Take Shelter in Trading Plans, *The Wall Street Journal* (Apr. 24, 2013); see also Jean Eaglesham and Rob Barry, Trading Plans Under Fire, *The Wall Street Journal* (Dec. 13, 2012).

The Sidley commenters recommend that the SEC revise its proposal to require that a shareholder must have continuously held at least 3% of the total voting power of a company's securities for at least three years in order to request the use of a universal proxy card.

available here) expressing their belief that the proposed rule, as drafted, is the equivalent of "proxy access on steroids." Compared to Exchange Act Rule 14a-8 and the vacated "proxy access" Exchange Act Rule 14a-11, the proposed rule would confer substantially greater rights to shareholders: a dissident shareholder would face almost no limitations when exercising this proposed rule that would allow it to replace the *entire* board of directors. Unlike Rules 14a-8 and 14a-11, the proposed rule does not contain any minimum ownership and holding requirements or related restrictions on the right of use. Therefore, the Sidley commenters recommend that the SEC revise its proposal to require that a shareholder must have continuously held at least 3% of the total voting power of a company's securities for at least three years in order to request the use of a universal proxy card. They also recommend that the SEC add certain other limitations on the right to use universal proxies, as it has done with Rule 14a-8 and Rule 14a-11. The Sidley commenters argue that imposing these requirements and restrictions would promote good faith use of the shareholder right afforded by the proposed rule and guard against undue imposition on companies and shareholders of the costs and distractions associated with dissident director nominations.

SIDLEY RESOURCES

Shareholder Activism

Shareholder Activism and ESG: What Comes Next, and How to Prepare. The recent successes of shareholder activists against Big Oil are one of many signs of mounting and effective pressure from investors on public companies to enhance their performance and disclosures on ESG criteria. This article provides background on the potential for increased integration of ESG in shareholder activism campaigns and offers practical guidance for companies to preempt ESG-themed shareholder activism.

Corporate Governance

Addressing Social Justice Issues: Implications for the Board. In an article published in the April/May 2021 edition of Practical Law's *The Governance Counselor*, Sidley partner Holly J. Gregory discusses the current pressures on companies to address issues of social justice and the key implications for boards.

SPACs and Delaware Fiduciary Duties. Special purpose acquisition companies, or SPACs, are popular new tools for raising capital that have garnered significant attention and momentum over the past year. There have been few fully litigated cases relating to SPACs. Although many of the cases filed have focused on federal securities law, the nature of SPACs and so-called de-SPACing transactions also potentially implicate a host of state law issues, particularly in connection with the fiduciary duties of directors. This article addresses several issues under Delaware law and how the unique features of SPACs may affect the applicability of those rules.

Sidley lawyers Holly J. Gregory, Rebecca Grapsas and Claire H. Holland recently updated the U.S. chapter of *Getting the Deal Through — Corporate Governance 2021*, an annual summary of key corporate governance practices in 19 jurisdictions worldwide. Their chapter addresses topics including sources of governance rules and practice, shareholders' rights, duties and liability, anti-takeover devices, board structures, legal duties of the board and disclosure and reporting requirements.

Litigation Trends

Maybe ESG Derivative Cases Aren't Going to be a Thing After All? Starting last summer, a series of derivative cases were filed against boards of a number of public companies alleging that the boards failed to create meaningful diversity in their boardrooms and among the senior management ranks. These cases, filed mostly by one law firm and primarily in the Northern District of California, had the markings of becoming a new genre of claim. As of spring 2021, two of these cases had proceeded through their first motion hearing and neither survived intact: *Ocegueda v. Zuckerberg et al.* (the Facebook case) and *Lee v. Fisher et al.* (the Gap case). Although other cases remain pending, and perhaps these two will be refiled, judicial reaction so far suggests that other methods to promote diversity may have greater impact.

Nevada Splits from Delaware, Applies Business Judgment Rule Broadly. Nevada has long been in competition with Delaware as a potential place of incorporation. A recent decision by the Nevada Supreme Court may further cement Nevada's status as a potential competitor to Delaware for certain corporations by demonstrating the difficulty of rebutting the business judgment rule.

SEC Enforcement

SEC Announces Settled Charges Against First American for Cybersecurity Disclosure Controls Failures – Lessons Learned (June 24, 2021). On June 15, the SEC announced settled charges against First American Title Insurance Company for disclosure controls and procedures violations related to a cybersecurity vulnerability that exposed sensitive customer information. First American agreed to a cease-and-desist order and to pay a $487,616 penalty, which highlights the SEC's continued focus on cybersecurity and provides helpful guidance for how the SEC Enforcement Division's Cyber Unit will enforce the SEC's interpretative guidance on cybersecurity disclosure requirements. This Sidley Update discusses the SEC's public guidance with respect to cybersecurity and disclosures, the key allegations in the SEC's order, and lessons learned.

Antitrust

Sidley partners Karen Kazmerzak and David C. Giardina wrote the U.S. chapter of *Getting the Deal Through—Vertical Agreements 2021*, a book intended for in-house counsel that provides an overview of antitrust regulation of distribution agreements in 19 jurisdictions worldwide.

SIDLEY EVENTS

CFPB: Preparing for the Enforcement Tsunami
July 14 | Webinar

The Biden era of enforcement at the Consumer Financial Protection Bureau (CFPB), while quiet so far, is about to ramp up with the confirmation of FTC Commissioner Rohit Chopra as the new CFPB Director. Please join us as we discuss what to expect from the CFPB in the Biden Administration, and how to prepare for what promises to be a historically aggressive financial enforcement regime. Sidley partner Thomas Ward, who recently served as the CFPB Enforcement Director and oversaw the formulation of the enforcement priorities that will guide the CFPB for years to come, will discuss what CFPB enforcement will look like in the Biden Administration. In addition to CFPB enforcement, this webinar will also provide insight on what to expect from the CFPB in the regulatory and rulemaking space. For more information or questions, please contact nyevents@sidley.com.

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