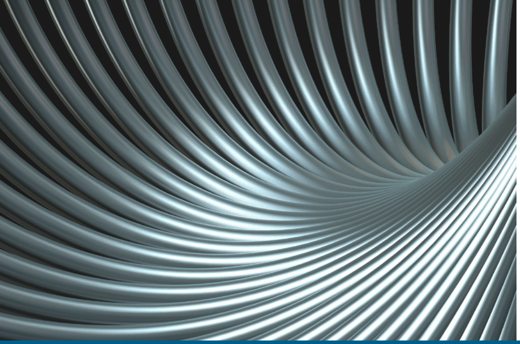

Sidley Perspectives
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ANALYSIS

"FRAUD ON THE BOARD"—WHEN ARE THE VICTIMS AT FAULT?

By Thomas A. Cole and Scott A. Gregus[1]

There are many examples of an individual board member being faulted (and even excoriated) in a judicial opinion for failing to be candid with their colleagues and withholding material information at the time of critical decision-making. Under what circumstances would—or should—deceived colleagues be deemed to be at fault for not knowing that critical information had been withheld from them? If so, what is the nature of such a failure, and how can it be prevented?

Delaware judges have not held back in their criticism of a board member who has failed to be forthcoming with colleagues. One of the earliest and strongest statements along these lines was in a 1989 opinion of the Supreme Court in *Mills v. Macmillan*. There the Court criticized three directors who failed to disclose to their colleagues that they had tipped off their favored bidder. The directors had a "... rigorous affirmative duty of disclosure [to fellow directors][,]…[their] silence was misleading and deceptive[,]…[and] it was a fraud upon the board." *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1283 (Del. 1989).

There are a number of more recent examples:

- In a 2018 opinion, the Supreme Court cited *Macmillan* and other cases for the proposition that "... directors have an 'unremitting obligation' to deal candidly with their fellow directors." *Morrison v. Berry*, 191 A.3d 268, 284 (Del. 2018). In that case, it was alleged that a CEO/director had misled the rest of the board about his commitment about rolling over his equity to one of the potential bidders for his company. *Id.* at 272-74.
- A few months later, the Court of Chancery stated that "... by withholding…information from the rest of the board, [a director] breached his fiduciary duty…." *In re PLX Tech. Inc. S'holders Litig.,* No. 9880-VCL, 2018 WL 5018535, at *47 (Del. Ch. Oct. 16, 2018). In that case, the uncandid independent director was a manager of an activist hedge fund who had recently forced his way onto the board and into leading a sales process. He (and the company's financial advisor) withheld information about certain communications with a bidder. *Id.* at *1, *2.
- In 2020, the Supreme Court considered a CEO/director who had failed to disclose discussions about proposed post-merger compensation in the combined company with a major shareholder of the counterparty. While the Court of Chancery held that "... the facts alleged do not support a finding of deceptive silence, fraud on the board, or a conflicted negotiator gone rogue" and granted the defendants' motion to dismiss, the Supreme Court disagreed, reversed and remanded. *City of Fort Myers Gen. Emp. Pension Fund v. Haley*, 235 A.3d 702, 716, 724 (Del. 2020).
- And in 2021, the Court of Chancery called out the fact that an independent director "... concealed…misconduct [of the representative of a controlling shareholder] … from the full…Board. And throughout…negotiations…acted as a backchannel for [that representative]." *In re CBS Corp. S'holder Class Action and Deriv. Litig.*, No. 2020-0111-JRS, 2021 WL 268779, at *40 (Del. Ch. Jan. 27, 2021).

It seems apparent that an uncandid director is likely to be deemed to be in violation of the duty of loyalty, because withholding information can easily be attributed to furthering his or her personal interests.

The fundamental fiduciary duties of directors and officers are care and loyalty. It seems apparent that an uncandid director is likely to be deemed to be in violation of the duty of loyalty, because withholding information can easily be attributed to furthering his or her personal interests. This is clear from *Hollinger v. Black*, in which the Court of Chancery held

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that a CEO/director "...violated his fiduciary duty of loyalty by…misleading his fellow directors about his conduct and failing to disclose his dealings…under circumstances in which full disclosure was obviously expected." *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1061 (Del. Ch. 2004).

A number of questions are worth pausing over.

First, because lack of candor with fellow board members rises to the level of a breach of fiduciary duty only when the information withheld is "material," what is the standard applied to determine materiality? Presumably, the Delaware courts would apply the same standard that applies in cases involving the duty of candor to shareholders. In *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985), the Delaware Supreme Court adopted the materiality standard used by the U.S. Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 439 (1976)—"An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote…It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote…." This formulation was echoed in the *PLX* opinion mentioned above with the words "[n]o one can tell what would have happened if [the uncandid director] had been candid, but the Board might well have proceeded differently." 2018 WL 5018535, at *47. In the *Haley* case, described above, the defendants argued—unsuccessfully—that the board understood the CEO would receive more compensation from the post-merger company and that, therefore, the details of the discussions were not material. That result, taken together with the Delaware position on "partial disclosure materiality" (see *Arnold v. Soc'y for Savings Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994)), suggests strongly that full transparency with colleagues on the board is the safest approach to take.

Second, are the directors who have been deceived by an uncandid colleague simply victims, or have they breached their fiduciary duty for failure to anticipate and deal with a lack of candor caused by a conflict of interest? The answer "yes" is what the plaintiffs in *Haley* asserted explicitly. In that case, the plaintiffs argued that the uncandid CEO/director's fellow directors "... breached their fiduciary duties by failing to oversee [the CEO's] negotiations." 235 A.3d at 715. Similarly, the Court of Chancery in *PLX*, after declaring that the uncandid director breached his fiduciary duty, added "... and induced the other directors to breach theirs." 2018 WL 5018535, at *47. This approach of victim-at-fault echoes the holding and language of the *Rural Metro* case. While that case related to a financial advisor's undisclosed conflict of interest, the language of the opinion was broader in scope. "Another part of providing active and direct oversight [of a sales process] is acting reasonably to learn about actual and potential conflicts faced by directors, management, and their advisors." *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54, 90 (Del. Ch. 2014).

After *Rural Metro* (and similar decisions), it has become standard practice to do due diligence on potential financial advisor conflicts. This is reasonable because of the nature of their business and the incentives that are assumed to drive investment bankers. Even before *Rural Metro*, because of the language in the *In re Toys "R" Us, Inc. S'holder Litig.* case from 2005, well-advised boards would take steps to make sure that their lead negotiator (typically a CEO) would not become enamored of, and favor, one bidder over another because of personal considerations. The Court of Chancery in *Toys "R" Us* heaped praise on a CEO/director who took diligent steps to assure a neutral bidding process, noting that he "... never tilted the process towards any bidder—he expressly refused to discuss his future with any bidder, and made sure that other members of management also refrained from doing so." 877 A.2d 975, at 1004. Cases like these have encouraged companies to take careful actions to manage potential conflicts. For example, a CEO is often directed not to discuss his or her role or compensation in the post-transaction company until a winning bidder has been selected by the board and all key terms pertinent to the shareholders have been agreed to, at least in principle.

The question then is "what is acting reasonably to learn about actual and potential conflicts" of, or lack of candor on the part of, fellow *independent* directors? An appropriate standard would seem to require some degree of investigation and heightened oversight, *particularly* if the independent director has certain attributes that make conflict or lack of candor somewhat likely. The classic case may be based on the fact pattern in *PLX*: if the independent director is the representative of an activist hedge fund or is a person who has otherwise demonstrated an interest in a short-term solution, rather than what would be in the long-term interest of the majority of the shareholders. Another situation might be this: if an independent director has an especially close personal or business relationship with a clearly conflicted director, which is the kind of relationship that might be disqualifying for membership on a special litigation committee under an analysis like that in the Court of Chancery's *Oracle* decision. *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003).

Third, if the deceived directors do have a fiduciary duty along the lines described above, is a failure to discharge that duty a breach of the duty of care (and is thus exculpated for the deceived directors), or is it a breach of the duty of loyalty? Intuitively, and in keeping with the decision in *Rural Metro*, when the directors are victims of deception, they have failed to comport with their duty of care rather than loyalty. That said, remember the language of the Delaware Supreme Court in *Marchand*—"If *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of the duty of loyalty." *Marchand v. Barnhill*, 212 A.3d 805, 824 (Del. 2019). And also consider the broader historical context of seemingly ever-increasing expectations by judges of corporate directors.

To exercise some degree of oversight over independent directors, a board may considering asking them (1) at the outset of a process, and thereafter periodically, to confirm that they have no conflicts and (2) whether they have had any direct or indirect communications with potential counterparties to a transaction, prior to or during the pendency of a sales process.

Because of the risk that a court could latch onto the language of *Marchand* and consider a failure to make any effort to detect potential deception on the part of fellow directors to be a breach of the duty of loyalty, it would be prudent, under certain circumstances, to exercise some degree of oversight even over directors who qualify as independent. One way to do this would be to ask all of the directors at the outset of a process, and thereafter periodically, to confirm that they have no conflicts. Consider, also, asking whether they have had any direct or indirect communications with potential counterparties to a transaction, prior to or during the pendency of a sales process.

Fourth, in the (hopefully) unlikely event that a court does not follow *Rural Metro* and the victims of the fraud on the board have unexculpated liability, what recourse might they have against their uncandid colleague? It appears that directors in Delaware may have the ability to recover in these situations. The relevant statute to consider is the Uniform Contribution Among Tortfeasors Act. The Court of Chancery has made it clear that this statute would apply in these circumstances because "[a] breach of fiduciary duty is easy to conceive of as an equitable tort." *Hampshire Group, Ltd., v. Kuttner*, No. 3607-VCS, 2010 WL 2739995, at *54 (Del. Ch. July 12, 2010). The statute establishes that a plaintiff can collect the entirety of a judgment from any of the multiple tortfeasors in an action. It also provides for the right of contribution, meaning that a tortfeasor who has paid his or her portion of a judgment can initiate a suit against a fellow tortfeasor to recover that portion. It is important for directors to note that Delaware courts do not consider relative degrees of fault when assigning pro rata shares of liability unless a cross-claim is filed between the tortfeasors on that issue. *Ikeda v. Molock*, 603 A.2d 785, 786-87 (Del. 1991). Therefore, directors who carefully follow the correct procedure may be able to seek recovery from their uncandid colleagues.

Fifth, when should a board be concerned about the requirement of candor and being a victim-at-fault? All of the cases discussed above have involved M&A transactions in which the majority of the board was deceived by one or a few directors. It is not a huge leap to apply the learning of those cases to other fact patterns. In a 2016 order, the Supreme Court reviewed a Court of Chancery decision involving the failure of the majority of a board to apprise a fellow director that the purpose of a special meeting was to consider an amendment to that director's stockholders agreement. The language of the order echoed the harshness of the opinion in *Macmillan*—"...we are uncomfortable embracing the idea that cliques of the board may confer and sandbag a fellow director"—and referred to "Pearl Harbor-like plans" on the part of a board faction. *OptimisCorp v. Waite*, No. 523, 2015 WL 2585871, at *2, *3 (Del. 2016). The order went on to say "[t]he Court of Chancery's opinion can be read as indicating that a board faction may engage in deception…so long as the faction subjectively believes that its intended end is good for the corporation. Nothing in our affirmance should be read as endorsing that view." *Id.* at *3. Furthermore, directors should be constantly aware of this requirement of candor, as the Supreme Court held in the *Bäcker v. Palisades Growth Capital* case earlier this year that the "…[duty of candor] principle applies with equal force to regular and special board meetings." 246 A.3d 81, 107.

Consider also a hypothetical that, regrettably, may be more of a common occurrence. Suppose a director becomes aware of a #MeToo allegation against the CEO. Would a failure to bring that to the attention of the rest of the board violate the director's "unremitting obligation of candor"? Would that depend on whether the allegation is credible, in the judgment of the informed director? If a failure to bring the allegation to the full board is a breach, is it one of care or loyalty, and does that in turn depend on the relationship of the uncandid director and the CEO? And can the other directors be faulted if they know that the CEO and uncandid director are close friends?

A board may consider making explicit – in the corporate governance guidelines or otherwise – the expectation that all directors are expected to share, with the other members of the board, material information that is or may be pertinent to the board's exercise of its fiduciary duties in decision-making and oversight.

Finally: What other steps might a board take to be reasonably assured that it is not being defrauded by silence in any context? A specific step would be to make explicit—in the corporate governance guidelines or otherwise—the expectation that all directors are expected to share, with the other members of the board, material information that is or may be pertinent to the board's exercise of its fiduciary duties in decision-making and oversight. For example, some companies include language in the "performance criteria for directors" sections of their guidelines requiring "candor toward other directors, management and professionals retained by the company, the board or its committees." This formulation clearly addresses the "fraud on the board" issue and is preferable to a simple reference to a director's duty of candor, which could be construed as referring only to the duty to be candid with shareholders. *Malone v. Brincat*, 722 A.2d 5 (Del. 1998).

More generally, a board should apply the Reagan-era arms control proverb: "Trust but verify." Trust, because trusting one's colleagues is the appropriate default position in the vast majority of situations. Moreover, a collegial and collaborative atmosphere in a boardroom is a useful attribute for effective corporate governance, especially at a time when important decisions are being made, and requires a sense of mutual respect and trust. But verify, because that seems to be both prudent and what the courts now expect. But do so in a diplomatic and non-abrasive manner so as not to unnecessarily damage the ethos in the boardroom.

IMPACT OF THE WHITE HOUSE'S FAR-REACHING EXECUTIVE ORDER ON COMPETITION POLICY

By Jim Lowe[2]

On July 9, the White House issued an Executive Order outlining the President's views of and expectations for antitrust enforcement during this Administration.[3] This may prove to be one of the most consequential statements of antitrust policy in at least 40 years. The Order is directed at more than a dozen federal agencies and contains nearly 75 separate initiatives aimed at increasing competitiveness in the economy and increasing enforcement of various laws intended to protect or strengthen competition. In addition, the Order creates a White House Competition Council chaired by the Director of the National Economic Council and includes the heads of eight Cabinet agencies or their designees.

Background

Antitrust enforcement has become increasingly politicized over the past decade and particularly in the past five years. Politicians from both parties having increasingly offered views on antitrust policy, expressed concerns about underlying issues of corporate consolidation across various industries, and called for greater enforcement and possible new legislation. President Joe Biden's campaign platform called for substantially increased antitrust enforcement to address perceived negative economic effects of dominant firms and reduced competitiveness from increased concentration in the economy. Early in his term he nominated Lina Khan, a vocal critic of large high-tech firms and corporate power, to be a Commissioner of the Federal Trade Commission (FTC). Moments after the Senate confirmed her, the President designated her Chair of the FTC. More recently he has nominated Jonathan Kanter, an advocate for companies opposed to Google's acts and practices, to be the Assistant Attorney General in charge of the Antitrust Division.[4] Under Chair Khan's leadership, the FTC has already taken a number of steps signaling an intent to increase both its merger and conduct enforcement, including most recently withdrawing the *Vertical Merger Guidelines* that had been issued during the Trump Administration.

The Executive Order is intended to put a significant portion of the Adinistration – including a number of independent agencies – on notice that the White House expects a focus on competitive issues, whether those be in health care, transportation, labor, agriculture, defense or financial services.

The Executive Order is intended to put a significant portion of the Administration—including a number of independent agencies—on notice that the White House expects a focus on competitive issues, whether those be in health care, transportation, labor, agriculture, defense or financial services. It also has attracted significant media coverage, which has created greater attention to the underlying issues.

The Executive Order

The Executive Order, which covers some 17 printed pages, addresses a wide variety of industries and conduct. It focuses on enforcement of the existing antitrust laws, which the White House believes needs to be more aggressive. Among its instructions to the Department of Justice (DOJ) and FTC are:

- Consider revising the 2010 *Horizontal Merger Guidelines* to cover more transactions; both agencies have indicated they are already reviewing possible revisions.
- Review past transactions that were not challenged at the time of their consummation and determine whether they should be challenged now.[5]
- Consider banning most, if not all, employee non-competes.
- Ban all forms of "pay-for-delay" settlements of intellectual property litigation.
- Consider revising the bank merger guidelines that were jointly issued by the DOJ and the relevant banking regulatory agencies.

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3 The Executive Order on Promoting Competition in the American Economy is available here and a "Fact Sheet" on the Executive Order is available here.

4 Kanter is expected to be confirmed later this fall or early in 2022.

5 An illegal merger is considered a continuing violation of Section 7 of the Clayton Act, so there is effectively no statute of limitations on the government bringing a merger challenge, even well after the transaction has closed.

- Increase merger and conduct enforcement scrutiny in the agriculture, health care, pharmaceutical and tech sectors (including Internet access), as well as any highly concentrated industries.
- Pursue transactions or conduct that lessen competition in labor markets.

Both antitrust enforcement agencies have stated their intent to comply with all of the Order's directives as well as policies developed by the Competition Council.

The Order also specifically called out a number of other federal agencies with instructions or recommendations to increase enforcement that protects or promotes competition. Among these are:

- The Department of Agriculture, to increase the enforcement of the Packers and Stockyards Act[6] which is intended to protect competition in meatpacking and associated industries.
- The Federal Communications Commission, to reinstate net neutrality rules.
- The Department of Health & Human Services, to speed the introduction of biosimilar drugs and to take other steps to reduce prescription drug costs, including, in conjunction with the Food & Drug Administration, to permit states and Tribes to import drugs from Canada.

Impact of the Executive Order

The Executive Order has spawned antitrust enforcement and regulatory decision-making across the government. Both the FTC and DOJ have cited the Order as justification for new enforcement initiatives, including the FTC's withdrawal of the *Vertical Merger Guidelines*. The Department of Agriculture has announced enforcement initiatives related to the Packers and Stockyards Act, including closer coordination with the DOJ. The Chairman of the Surface Transportation Board has urged the railroad industry to focus on investment and increased service over consolidation and corporate restructuring. And most recently, the Department of Transportation reallocated landing slots at Newark Airport to a low-cost carrier rather than retiring those slots. In doing so, the Department noted its desire to increase competitiveness in the airline industry.

While not every initiative listed in the Executive Order is likely to be implemented, we expect government agencies will continue to focus on competition during the course of this Administration, and that the antitrust agencies will more stringently enforce the antitrust laws across all industries.

While not every initiative listed in the Executive Order is likely to be implemented, we expect government agencies will continue to focus on competition during the course of this Administration, and that the antitrust agencies will more stringently enforce the antitrust laws across all industries. This means parties to strategic transactions will face closer examination and longer reviews. We also expect the agencies to challenge transactions that might have been cleared in prior Administrations. In line with the Executive Order mandate, the antitrust agencies will look for cases against firms with large market shares where there is evidence those firms used anti-competitive means to obtain or maintain those shares. Similarly, other agencies with authority to protect or increase competition will institute more aggressive rules or increase enforcement. The agriculture, banking, communications, high-tech, health care, pharmaceuticals and transportation industries can expect additional scrutiny. But the scrutiny will extend to mergers in any markets with four or fewer significant participants.

Companies in those industries or considering strategic transactions, regardless of the industry involved, should view the Executive Order as signaling a significant change in how enforcers will approach them and their activity and should plan accordingly.

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6 7 U.S.C. § 181 et seq.

ESG DISCLOSURES IN PROXY STATEMENTS: BENCHMARKING THE FORTUNE 50

By Rebecka Manis, Lindsey Smith and Sonia Gupta Barros[7]

It is no secret that the Securities and Exchange Commission (SEC) has recently ramped up its focus on environmental, social and governance (ESG) disclosures. In February 2021, Acting SEC Chair Allison Herren Lee directed the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings, including reviewing the extent to which public companies address the topics identified in the SEC's 2010 Guidance Regarding Disclosure Related to Climate Change. Then, in March 2021, she requested public comment on climate change disclosures (which has generated over 600 comment letters, the vast majority of which are supportive of mandatory climate disclosure rules), and new SEC rules on climate risk and human capital disclosures are expected to be proposed yet this year. In addition, holding true to its "all-of-SEC" approach to ESG, the SEC has formed a Climate and ESG Task Force (composed of 22 members and led by the Acting Deputy Director of Enforcement), which will use data analytics to look for material gaps and misstatements in climate risk disclosures under existing rules.

This increased focus of the SEC is driven by increased investor interest in ESG, which is perhaps most strikingly apparent in the recent move by investors in getting three directors elected to the board of ExxonMobil, and the heightened public scrutiny of corporate political donations in the wake of the Capitol riot. But it is also evident in the record number of shareholder proposals on environmental and social topics in the 2021 proxy season, which have seen a significant surge in support from institutional investors. Businesses too have signaled a shift in focus, away from a single-minded pursuit of shareholder profit and toward creating value for all stakeholders.

Sidley has been tracking the progression of this focus on ESG, providing a multi-disciplinary website that includes insight on the landscape of ESG disclosures and the SEC's going-forward priorities, provides industry-specific advice and offers guidance on how companies can prepare for the potential for increased ESG in shareholder activism. But although these articles caution that companies lagging behind their peers may be more likely to see integration of ESG in shareholder activism campaigns, and that outliers may find themselves potential targets for SEC enforcement, there is no clear understanding of what it means to be an ESG "laggard" or "outlier." This article benchmarks what it might mean to be an exception to these undefined ESG "rules" by analyzing the ESG disclosures in the most recent proxy statements of Fortune 50 companies.

How is ESG Defined?

As is evident from the name, "ESG" has three prongs: the *environmental* prong, which covers topics such as climate change, greenhouse gas emissions, air and water pollution, energy consumption, water usage, waste and recycling and environmental justice; the *social* prong, which includes workplace and product safety, employee diversity, equity and inclusion, nondiscrimination and fair pay, collective bargaining, human rights, charitable contributions and community programs, cybersecurity and data privacy and supply chain management; and the *governance* prong, which encompasses issues such as compliance, corporate purpose and stakeholder interests, board diversity, declassification and independence, executive compensation and political contributions and lobbying. But it is not at all evident which information of this multitude may be most valuable to a company's investors or what it means to provide meaningful disclosure with respect to any or all.

For U.S. public companies, the SEC is perhaps the most influential authority in determining what is material, but the SEC has only recently become focused on expanding mandatory ESG disclosures, and we do not anticipate formal rule proposals to be made until mid- to

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late fall. We do, however, have some sense of what to expect based on recent statements made by SEC Chair Gary Gensler.

During his confirmation hearing, Chair Gensler indicated his support for additional disclosures on climate risk, diversity, human capital and political spending, and his more recent statements suggest that the SEC will propose an ESG disclosure regime specific to the U.S. markets. Chair Gensler has also signaled that the human capital disclosure requirements could address metrics such as workforce turnover, skills and development training, compensation, benefits, workforce demographics (including diversity) and health and safety. Additionally, based on Chair Gensler's more recent remarks on climate change and in particular on greenhouse gas emissions, it seems likely that the SEC will require Scope 1 and Scope 2 disclosures; Scope 3 disclosures could also be required, but perhaps only under certain circumstances.

In September, the SEC published a letter highlighting sample comments that the Division of Corporation Finance may issue to companies regarding their climate-related disclosures or lack thereof. For now, the Division's focus seems to be the extent to which a company has addressed the topics identified in the SEC's 2010 guidance on climate change disclosures.

More generally, Chair Gensler has also said that the framework for disclosures will seek consistent and comparable information that is "decision-useful" (i.e., disclosures that contain sufficient detail such that investors gain helpful information in order to make an investment or voting decision) and that incorporates both qualitative and quantitative data. The framework will also likely include industry-specific metrics and support forward-looking commitments (e.g., "net zero" pledges, or commitments required by the jurisdictions in which companies operate). The SEC may require scenario analyses as well, on how a business might adapt to the range of possible physical, legal, market and economic changes it could contend with in the future, and general governance, strategy, and risk management related to climate risk. The SEC is also considering where these disclosures belong, for example, in the annual report on Form 10-K—alongside other information that investors use to make their investment decisions—or elsewhere.

In the absence of a finalized comprehensive regulatory framework, however, proxy advisory firms, nongovernmental reporting organizations, state laws and the continued listing requirements of securities exchanges have been the key players in standardizing ESG metrics. The introduction of the ISS Environmental & Social QualityScore in 2018 helped set the stage for public companies, and both ISS and Glass Lewis have since significantly expanded their evaluation of environmental and social topics. Nongovernmental reporting organizations have also gained prominence as standard setters, in particular the Taskforce on Climate-Related Financial Disclosures (TCFD), the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI).[8] Additionally, we are seeing states pass laws that impose varying requirements with respect to board diversity, such as California's board diversity requirements and the diversity reporting requirements in Illinois, as well as requirements from securities exchanges that require listed companies to make certain diversity disclosures, such as those from Nasdaq.[9]

What ESG Disclosures Are Being Made?

But within this network of standards, what disclosures are actually being made by public companies in their SEC filings? To answer this question, we evaluated the most recent proxy statements of Fortune 50 companies. We recognize (and indeed, our review confirmed) that most of these companies publish more fulsome ESG disclosures on their websites in standalone ESG reports, and may also have relevant disclosures in other public filings, particularly in their annual report on Form 10-K as it relates to human capital management disclosures. That said, a review of the most recent ESG disclosures that Fortune 50 companies have made in their proxy statements is a useful indicator of what it may mean to be an "outlier" or "laggard" in SEC filings. Based on the expected rule proposals from the SEC, company disclosures are categorized into one of three broad categories—climate

8 There is also a push among some nongovernmental standard-setting organizations—TCFD, SASB, and GRI included—to create uniform global sustainability standards in collaboration with the International Financial Reporting Standards Foundation.

9 For a more comprehensive overview of applicable laws, regulations, and other actors, please see the Sidley-authored chapter in *Getting the Deal Through*—Impact Economy 2021, which is available here.

change, human capital and board diversity—and we evaluated trends across the Fortune 50. The analysis also notes the companies' ESG governance structure and any areas of frequent disclosure that fall outside of these three categories.

Governance. Approximately 60% of the Fortune 50 companies reported that two or more committees oversee ESG matters; where there is only one oversight committee, it is most often the Nominating and Governance Committee (7), followed closely by a public affairs committee (6). Only four companies delegated oversight exclusively to a specific ESG committee. Overall, companies reported that they delegated oversight among their Nominating and Governance Committee (60%), Compensation Committee (40%), Audit Committee (24%), public affairs committee (26%) and/or a specific ESG committee (18%).

Climate Change. Overall, 90% of companies made specific climate change disclosures, in particular with respect to reducing or eliminating carbon emissions (65%), use of renewable energy (46%) and on sustainability efforts, both in terms of products (28%) and supply chains (22%), with disclosures regarding water use being more associated with the manufacturing industry. Approximately 90% of companies also stated that ESG disclosures could be found on their website, and three (7%) also indicated that further information was disclosed in their annual report on Form 10-K.

Companies should (1) compare their ESG disclosures to the disclosure trends in their industry to identify any gaps, (2) evaluate whether and how the company can work to incorporate ESG disclosures into their proxy statements consistent with industry peers and (3) ensure that the company has procedures and controls in place to operate consistent with any disclosures.

Human Capital. Most companies also made specific human capital disclosures. With respect to diversity, equity, and inclusion (DEI) topics, the most discussed topic was community engagement and/or donations made (52%), followed closely by efforts to increase representation at the company (50%) (although only 26% committed to disclosing EEO-1 diversity statistics). Health and safety disclosures were relatively common, with 39% reporting on specific employee well-being and 37% on COVID-19 matters. Employee resource groups (26%) and educational efforts (26%) were also common topics for disclosure. Less common were racial justice issues (20%) and inclusion training (17%).

Board Diversity. Every Fortune 50 company disclosed board diversity statistics, with 96% reporting as to gender and 91% reporting as to race and ethnicity (three companies reported general diversity statistics that were not subdivided into distinct categories, and two companies reported specific diversity statistics only as to gender).

Other Areas. Shareholder outreach was by far the most common other area discussed (90%), although lobbying and political activity (35%), governance matters (28%), employee engagement (28%) and privacy (20%) were also regular topics. Approximately 20% of companies made disclosures about ESG-related compensation incentives.

Reporting Frameworks. SASB was the most frequently cited ESG reference framework (35%), although TCFD (33%) and GRI (26%) were not far behind. About 39% of companies referenced other nongovernmental standards, including the United Nations (UN) Sustainable Development Goals (8), the Science Based Target Initiative (3), the UN Guiding Principles on Business and Human Rights (3) and RE100 (3).

For a summary of the ESG proxy statement disclosures of Fortune 50 companies broken down by industry, see our complete Sidley Update available here.

What Should Companies Do Next?

Understanding the ESG disclosure trends both within in your industry and more broadly is important because we expect that the SEC may propose disclosures of industry-specific metrics and that the rulemaking may be informed in part by current levels of disclosure. Moreover, we expect that the SEC will leverage data analytics to look for material gaps and misstatements in ESG disclosures across companies.

In addition to evaluating industry trends, it is also important to ensure that any disclosures made accurately reflect current ESG practices and are realistic about ESG goals (i.e., companies should avoid "greenwashing"). Companies should also have adequate policies, procedures and controls in place to ensure they act consistently with such disclosures.

NEWS[10]

JUDICIAL DEVELOPMENTS

Caremark Claim Allowed to Proceed Against Boeing Directors for Failure to Implement and Oversee a Board-Level System to Monitor and Report on Airplane Safety

In September, the Delaware Court of Chancery allowed a derivate action against Boeing Co. arising out of two crashes of the company's 737 MAX aircraft to survive a motion to dismiss. *In re Boeing Co. Deriv. Litig.* (Dec. Ch. Sept. 7, 2021). This decision is the latest in a recent flurry of Delaware cases in which the courts have allowed so-called *Caremark* claims to proceed past the motion-to-dismiss stage. The common theme of these cases is that in each, the plaintiffs satisfactorily alleged that the company's board had failed either to establish or satisfactorily oversee a compliance system focused on the company's "mission critical" regulatory or safety-related risks. An important factor in several of these cases, including *Boeing*, was the board's failure to assign such responsibility to a specific board committee.

In *Boeing*, the plaintiffs alleged that the board had failed to establish a reporting system for airplane safety and turned a blind eye to safety red flags. According to the complaint, none of the company's board committees was specifically tasked with overseeing airplane safety, and every committee charter was silent with respect to airplane safety. The company's audit committee was tasked with overseeing legal and regulatory compliance but allegedly focused principally on financial and production risks and did not routinely discuss airplane safety. Compounding the issue, management did not report to the board on safety issues, and the board did not receive internal complaints about safety. Though it acknowledged the high bar to such cases proceeding, the Court held that the plaintiffs had made sufficient allegations against the directors and allowed the case to proceed.

Boards have a responsibility to ensure that systems are in place to identify and monitor compliance and safety risks on an ongoing basis, and they must do so "rigorously" with respect to "mission critical" risks. When, on a motion to dismiss, the record does not provide evidence that they have done so, the Delaware courts will allow cases against them to proceed.

In so doing, the Court relied heavily on the Delaware Supreme Court's 2019 decision in *Marchand v. Barnhill*. In *Marchand*, the Supreme Court focused on regulatory risk and held that board oversight of such risk must be "rigorously exercised" with respect to "mission critical" risks. Relying on *Marchand*'s precedent, the Court in *Boeing* found that the plaintiffs—closely tracking the allegation in *Marchand*—had adequately alleged that while Boeing's audit committee was charged generally with risk oversight, "no committee [was] charged with direct responsibility to monitor airplane safety;" that the board failed properly to monitor, discuss or address airplane safety issues; and that no regular processes or protocols had been implemented for reporting and addressing "red flags."

To mitigate this risk of a *Caremark* claim surviving a motion to dismiss, boards should ensure that mechanisms are in place to support rigorous board oversight of compliance and safety efforts. This should include the following:

- Periodically conduct a review of the business to identify mission-critical operations and risks.
- Review the reporting processes in place to ensure that information about mission-critical risks is brought to the board's attention in a manner that is not unduly dependent on management discretion.
- Ensure that the board is well positioned to engage in oversight in this area.
  - Establish a regular cadence for discussion of compliance and safety at board meetings.
  - Consider whether the board has clearly and adequately delegated to a current board committee responsibility for assisting the board in its oversight of compliance and safety risk or whether the board should establish a specialized committee for this task.

10 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Julia L. Bensur, Sara B. Brody, Colleen Theresa Brown, Stephen L. Cohen, Jim Ducayet, Thomas H. Collier, Matthew J. Dolan, Robert M. Garsson, Rebecca Grapsas, Holly J. Gregory, Claire H. Holland, Paul E. Kalb, M.D., Geta Malhotra, Jon W. Muenz, Charlotte K. Newell, Sujit Raman, Alan Charles Raul, Michael R. Roberts, Hille R. Sheppard, Laura C. Sorice, and Andrew W. Stern. Some of the pieces first appeared in Sidley's Enhanced Scrutiny blog, which provides timely updates and thoughtful analysis on M&A and corporate governance matters from the Delaware courts and, on occasion, from other jurisdictions.

  – Be sure committee charters clearly reflect the responsibilities delegated for compliance and safety.
- Document board and committee efforts in this area carefully in meeting minutes.

For more context on the *Boeing* decision, see the Sidley Update available here.

Bear Market for Plaintiffs' Liquidity-Based Conflict Allegations

Two recent Delaware Court of Chancery decisions suggest that liquidity-based conflicts, without more, are unlikely to invite enhanced scrutiny in the context of post-closing merger litigation.

In M&A litigation, plaintiffs' lawyers see actual or perceived conflicts of interest as gold. Conflict allegations can take many forms and arise in a variety of contexts: for example, a board member of a target company who is offered employment by the would-be acquirer, or a controlling stockholder who sits on both sides of a transaction. Another common example, and the focus of this piece, is a board member or stockholder whose financial interests are alleged to diverge from other stockholders because of a need or desire to quickly liquidate holdings (known as a liquidity-based conflict).

As discussed below, two recent Delaware Court of Chancery decisions have addressed liquidity-based conflicts in differing contexts but with similar results: in each case, the alleged conflicts turned out to be fool's gold.

Flannery v. Genomic Health, Inc. (Del. Ch. Aug. 16, 2021)

This recent decision from Vice Chancellor Joseph Slights concerned the 2019 merger in which Exact Sciences acquired Genomic Health for a combination of cash and stock. The plaintiff, a former Genomic stockholder, "pulled out all stops to implicate either entire fairness review or *Revlon* enhanced scrutiny in order to survive dismissal," with one such "stop" involving allegations of a liquidity-based conflict.

Two brothers and their affiliated companies (the Baker brothers) had at times held upward of 45% voting control of Genomic, although at the time of the merger their voting control had declined to approximately 26%. Under Delaware law, the highest standard of review—entire fairness—will apply, among other circumstances, where (1) "the plaintiff presents facts supporting a reasonable inference that a transaction involved a controlling stockholder" *and* (2) the controller "engages in a conflicted transaction" either by standing on both sides of the transaction *or* "compet[ing] with the common stockholders for consideration."

The plaintiff argued that the entire fairness standard of review should apply because the Baker brothers' minority stake was "potent" (which made them a "controller" despite their less-than-majority voting control) in combination with their "unique desire" to exit their investment (i.e., a liquidity-based conflict). As to the latter argument, the Court acknowledged that a "legally cognizable conflict" may arise "where the controller gets a 'unique benefit' by extracting something uniquely valuable to the controller, even if the controller nominally receives the same consideration as all other stockholders."

Another notable aspect of Flannery *beyond the scope of this piece is that Vice Chancellor Slights declined to apply* Revlon *enhanced scrutiny because stock comprised 58% of the merger consideration.*

The Court, however, did not credit the plaintiff's "conclusory" argument that "the Baker Brothers'…supposed desire to exit their investment in Genomic supports an inference that they directed the Board to recommend the Merger at an unfair price." Recognizing that, as a general matter, controllers have interests identical to other stockholders—"to maximize the value of their shares"—the Court noted recent decisions holding that liquidity-based allegations will rise to an actionable conflict only where the transaction is alleged to be a "fire sale" where the seller agreed to a sale without taking the usual steps to maximize value. A "mere desire to sell" cannot create an actionable conflict.

Because the "vague allegation that the Baker Brothers…sought liquidity, without more, does not suffice," the Court held that the Baker brothers were not conflicted controllers and that "there is no basis to review the Merger for entire fairness." For this, among other reasons that led to business judgment rule deference and/or exculpation, the plaintiff's complaint was dismissed.

Kihm v. Mott (Del. Ch. Aug. 31, 2021)

This recent decision from Vice Chancellor Morgan Zurn likewise involved an attempt to obtain enhanced scrutiny of a merger transaction — in which GlaxoSmithKline (GSK) acquired Tesaro Inc. — based on allegations of liquidity-based conflicts. Specifically, the plaintiff sought to portray a private equity sponsor and significant stockholder of the target, as well as its affiliated board member, as conflicted based on their "unique interest in selling Tesaro before year-end 2018" to raise money for a new fund. While superficially similar to the allegations in *Genomic*, the plaintiff's attempted use of those allegations differed materially.

Unlike *Genomic*, this case involved a "cash-out" merger, meaning the target's stockholders would receive only cash for their shares as opposed to stock in the acquirer. Cash-out mergers are "presumptively subject to at least enhanced scrutiny under *Revlon*" unless they have been "cleansed" pursuant to the Delaware Supreme Court's *Corwin* decision. Although not the focus of this article, in brief, "*Corwin* cleansing" affords business judgment rule deference to a cash-out merger where it has been ratified by a fully-informed, uncoerced vote by a majority of the target's disinterested stockholders.

Notably, while the complaint included numerous allegations about the sponsor's motivations, it did not assert that the sponsor was a controlling stockholder or otherwise allege "coercion." Instead, the plaintiff sought to evade *Corwin* on the grounds that the merger vote was uninformed. This is where the sponsor's purported conflict came into play. Rather than asserting that the liquidity-based conflict on its own was debilitating, the plaintiff alleged that the company's failure to *disclose* that conflict led to an uninformed vote.

Different approach; same result. The Court commented that the plaintiff was seeking an "extraordinary inference" that the sponsor had an interest in "short-changing itself" with respect to the transaction price "in favor of liquidity due to its investment life cycle and business model." The allegations were insufficient to support such an inference. Because the sponsor was not a controller, it "was not a fiduciary and did not have its own power to pressure or force Tesaro's sale."

Thus, whether the sponsor was conflicted was "not material on a standalone basis," but rather such conflicts were relevant "only insofar as they inform" whether the sponsor's board designee was conflicted. In that regard, the Court found that the sponsor designee's "dual fiduciary status" was adequately disclosed and that "[e]ven assuming [the sponsor] has divergent liquidity interests, those specific interests do not add to the total mix of stockholder information about [the sponsor] or the sale process."

As in *Genomic*, there was no other basis for enhanced scrutiny and, in the absence of waste allegations, the motion to dismiss was granted.

These are not the first decisions to view with skepticism allegations of liquidity-based conflicts. Nonetheless, they are welcome news for private equity sponsors and other investment entities who, by the very nature of their businesses, often seek "liquidity" for their investments in a way that may differ from the common stockholder base. Those business practices, without more, are unlikely to invite enhanced scrutiny in the context of post-closing merger litigation.

New York State Supreme Court Enforces an Exclusive Federal Forum Charter Provision, Continuing a Trend Started in California to Stem the Tide of 1933 Act Litigation

Recently the Supreme Court of the State of New York, County of New York enforced an exclusive federal forum charter provision and dismissed a putative securities class action brought under the Securities Act of 1933 because the company's charter provided that such lawsuits may be brought only in federal court. *Hook v. Casa Systems, Inc.* (N.Y. Sup. Ct. Aug. 31, 2021). The decision is the first in New York to address the enforceability of a Delaware corporation's exclusive federal forum charter provision since the Delaware Supreme Court held that such provisions are facially valid in *Salzberg v. Sciabacucchi* (Del. 2020), which was discussed in our June 2020 issue of *Sidley Perspectives*. *Casa Systems* follows four California state court decisions since *Salzberg* that have enforced federal forum provisions.[11]

In 2018, the U.S. Supreme Court held in *Cyan, Inc. v. Beaver County Employees Retirement Fund* that federal and state courts have concurrent jurisdiction over claims arising under the 1933 Act. In the wake of the *Cyan* decision, companies began adopting exclusive federal forum provisions requiring any actions arising under the 1933 Act to be litigated in federal district courts. A December 2018 Delaware Court of Chancery decision declared federal forum provisions illegal under Delaware law, but the Delaware Supreme Court reversed that decision in *Salzberg* in March 2020.

Casa Systems, Inc., a broadband service provider incorporated in Delaware with its only U.S. office in Massachusetts, faced a class-action lawsuit in New York state court brought by a shareholder against the company and certain of its directors, officers, IPO underwriters and investors following the company's initial public offering. The shareholder brought claims under Sections 11 and 15 of the 1933 Act. The defendants moved to dismiss the case based on the federal forum provision in the company's charter, which read as follows and is identical to one of the provisions upheld in *Salzberg*:

> Unless the Corporation consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall, to the fullest extent permitted by law, be the sole and exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring or holding any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to [this provision].

Judge Margaret Chan of the New York State Supreme Court granted the defendants' motions to dismiss on the basis of the federal forum charter provision. She applied the holding in *Salzberg* but noted that applying New York law instead would have yielded the same result. Under New York law, a federal forum provision will not be disregarded unless a party demonstrates that enforcement of the provision would be unreasonable or unjust—a burden the plaintiff did not meet. The Court also rejected the plaintiff's argument that he did not agree to the federal forum provision because the provision contains explicit language proving to the contrary. Finally, the Court denied two constitutional arguments made by the plaintiff based on U.S. Supreme Court precedent and because the process-oriented and non-substantive nature of the federal forum provision did not implicate the Commerce Clause.

Casa Systems is a welcome development for companies that have adopted federal forum provisions to increase efficiency in defending against 1933 Act claims.

Notably, *Casa Systems* confirms that, under Delaware and New York law, "non-signatories may be bound by or enforce a forum selection clause." Accordingly, the Court also dismissed the claims brought against the IPO underwriters and investors even though they were not parties to the charter.

The decision in *Casa Systems* is significant in that it is the first decision in New York to enforce an exclusive federal forum provision. If other state courts follow the lead of California and New York and find these provisions enforceable, securities litigation

11 *Wong v. Restoration Robotics, Inc.* (Cal. App. Dep't Super. Ct. Sept. 1, 2020) (discussed in our September 2020 issue of *Sidley Perspectives*); *In re Uber Tech., Inc. Sec. Litig.* (Cal. App. Dep't Super. Ct. Nov. 16, 2020); *In re Dropbox, Inc. Sec. Litig.* (Cal. App. Dep't Super. Ct. Dec. 4, 2020); and *In re Sonim Tech., Inc . Sec. Litig.* (Cal. App. Dep't Super. Ct. Dec. 7, 2020).

defendants may be able to successfully channel 1933 Act litigation into federal courts and avoid litigating duplicative claims in different jurisdictions. This, in turn, should decrease litigation costs for companies and increases the predictability of outcomes. However, as the trial courts' decisions are not binding on other courts and may be appealed, the enforceability of exclusive federal forum provisions remains subject to further judicial challenge. Given these developments, any company in the process of going public should adopt an exclusive federal forum provision. For existing public companies, we encourage consideration of adopting such a provision, bearing in mind that doing so without shareholder approval may cause Glass Lewis to issue a vote recommendation against the company's governance committee chair.

Bardy underscores the challenges of proving an MAE – particularly when the target company is in a highly regulated industry – and provides useful guidance for drafting disproportionality exclusions in an MAE clause.

In Case of Emergency, Break Glass: Litigation and Drafting Guidance From Delaware Court of Chancery Opinion on "Material Adverse Effect" Clauses

The Delaware Court of Chancery recently issued an opinion that confirms the difficulty of successfully invoking a "Material Adverse Effect" (MAE) clause in a merger agreement. *Bardy Diagnostics, Inc. v. Hillrom, Inc.*, C.A. No. 2021-0175-JRS (Del. Ch. July 9, 2021). In particular, the decision underscores the challenges of proving an MAE—particularly when the target company is in a highly regulated industry—and provides useful guidance for drafting disproportionality exclusions in an MAE clause.

The case involves a merger between Hill-Rom (Hillrom) and Bardy Diagnostics, Inc. (Bardy), a startup medical device manufacturer. Hillrom pulled out of the deal after a sharp, unexpected drop in the regulated Medicare reimbursement rates for Bardy's sole medical device, a portable heart-monitor patch. For years, government-set Medicare rates had stayed steady at $365 per patch. While Hillrom and Bardy were negotiating the merger agreement, there were signs that the government might even raise the rate by another $100. But just weeks after the parties entered into the final merger agreement, the entity with rate-setting authority sent the rate for Bardy's patches plummeting to just under $50 per patch. This was an 86% drop from the historic rate of $365 per patch, and meant that Bardy could not profitably serve Medicare customers.

The new rate caught both Hillrom and Bardy entirely by surprise. Both joined a full-court press with others in the industry to convince the rate-setting authority that the $50/patch price was mistakenly low. In response, the authority raised the rate to between $100 and $130 per patch. That was an improvement for Bardy, but still nearly 65% under the historic rate. Hillrom invoked the MAE clause in the merger agreement, and Bardy sued Hillrom in the Delaware Court of Chancery, seeking specific performance to force Hillrom to close the merger, as well as compensatory damages for failing to close as promised. The parties took the case to trial.

In an opinion by Vice Chancellor Slights, the Delaware Court of Chancery agreed with Bardy that the rate drop was not an MAE under the contract, and ordered specific performance of Hillrom's obligation to close the merger deal. The Court denied Bardy's request for compensatory damages.

First, in holding that the drastic rate drop was not an MAE, the *Bardy* Court held that the rate drop did not have a "material adverse effect" on Bardy because Hillrom failed to prove that it was "durationally significant," that is, that the rate drop threatened Bardy's long-term earnings over a "commercially reasonable period." The Court held that Hillrom did not meet its burden of proof to show that the unexpectedly new low rate would remain at that level for more than two years. After all, the rate-setting authority had historically set rates much higher for the heart-monitor patches, and it was and would be under pressure to raise rates given that the new lower rates might price patch manufacturers like Bardy out of serving Medicare patients. The facts seemed to suggest that the aberrantly low rates were exactly that: a temporary dip that would soon snap back to the higher historical baseline.

Second, as an alternative ground, the Court held that even assuming the adverse effect of the rate drop was "durationally significant," it could not qualify as an MAE under the contract because changes in law were carved out from the MAE definition. Under the merger agreement, a change in any "Health Care Law" cannot be an MAE. The Court held that the regulated rate met the definition under the merger agreement.

Third, assuming the materially adverse rate drop was "durationally significant" but was excluded from being an MAE because it was a change in a "Health Care Law," it could nevertheless qualify as an MAE if the rate drop had "a materially disproportionate impact on [Bardy] as compared to other similarly situated companies operating in the same industries or locations." The trouble for Hillrom was that Bardy was a sole-product manufacturer of a niche medical device with few competitors. The Court found that only one company was "similarly situated" to Bardy—another manufacturer of a similar heart-monitor patch product—and the rate drop had substantially the same effect on this competitor as it had on Bardy. So even if the *Bardy* Court had found that the rate drop met the initial definition of an MAE, it would not be saved from the "Health Care Law" carve-out because the drop in rates did not hurt Bardy any more than a company offering the same type of product, subject to the same rates.

There are several lessons from the *Bardy* opinion. Among them is that when seeking to invoke an MAE as a result of an unexpected and dramatic change in the regulatory environment, a party may face a dilemma: the very evidence necessary to show that the event is dramatic and unexpected may also show that the event will not become the "new normal" and could instead be reversed by a course-correcting regulator after lobbying and public backlash. As the *Bardy* Court stressed, the only change that Hillrom relied on was the reimbursement rate, but the evidence showed that "the way in which [the regulator] arrived at that rate is unclear; it revised the rate once in dramatic fashion and continues to engage in conversations concerning flaws in its pricing methodology." As such, Hillrom had not met its burden of proof. As the *Bardy* Court explained, it was insufficient to show that the impact of the new rates "*might* be durationally significant, as a mere risk of an MAE cannot be enough" (emphasis in original).

In addition, *Bardy* suggests that MAE clause drafters should pay careful attention to defining the target's peer group of companies for purposes of expanding the MAE definition to include disproportionate effects on the target. In *Bardy*, the parties used the term "similarly situated" to define the universe of comparable companies. By contrast, other litigated MAE cases involved broader language, such as "comparable entities operating in the same industry." As the *Bardy* Court emphasized, the specific language chosen by the parties is critical, and the use of the limiting phrase "similarly situated" here called for a "more granular parsing of a company's situation than mere participation in the [relevant] market." That meant, as a practical matter, the impact of the regulatory changes on Bardy would be measured against only one other company that, unsurprisingly, was also significantly impacted by those changes. Narrowly defining the peer group means that many adverse effects, particularly regulatory changes, may never be disproportionate enough to qualify for an MAE disproportionality clause.

When Even "Entirely Fair" Is Not Enough

In June, the Delaware Supreme Court reversed Chancellor Kathaleen S. McCormick's post-trial decision upholding a disputed stock sale after concluding that the sale satisfied the entire fairness standard of review. *Marion Coster v. UIP Companies, Inc.*, No. 49, 2020 (Del. June 28, 2021). Although the Court affirmed the trial court's entire fairness finding—Delaware's most rigorous standard of review under which a defendant must establish that a transaction was the product of both fair dealing and fair price—it nevertheless reversed because the Court of Chancery concluded that entire fairness was the "end of the road" for judicial review and declined to consider the board's motivations for the transaction. Invoking the principle expressed in the seminal Delaware opinion in *Schnell v. Chris-Craft* that "inequitable action does not become permissible merely because it is legally possible," the Supreme Court remanded the case for further consideration of the motivation for and purpose of the subject stock sale.

Coster arose from a control dispute over UIP Companies, Inc. Prior to the litigation, UIP was equally owned by plaintiff Marion Coster and defendant Steven Schwat. Coster had long been seeking a buyout, but when that did not come to fruition, she made several attempts to reduce or increase the size of the board in order to break a deadlock. When those attempts failed, Coster commenced litigation seeking the appointment of a custodian to break the deadlock.

In response, UIP's board—then comprising Schwat and two directors aligned with him—voted to issue a one-third interest in UIP to director Peter Bonnell, based on a valuation conducted by an independent third party (the Stock Sale). Coster then filed a second litigation in the Court of Chancery seeking to cancel the Stock Sale on the grounds that UIP's board breached its fiduciary duties in approving it.

Coster serves as an important reminder that even where a board follows an appropriate process and the result is "entirely fair" to the complaining stockholder, a court could still find that directors breached their fiduciary duties if they were motivated by inequitable reasons.

The Court of Chancery consolidated the two litigations and held a trial. It made several factual findings, including that the Stock Sale was intended to dilute Coster, entrench the board, and render moot the litigation in which Coster sought to appoint a custodian. It also found that Schwat and Bonnell were interested in the transaction. Nonetheless, applying the onerous entire fairness standard of review, the Court of Chancery concluded that the board engaged in a fair valuation process and approved the Stock Sale at a fair price, relying on, among other things, the independent valuation. Having reached that conclusion, the Court of Chancery declined to consider Coster's alternative arguments that the motivation and purpose of the sale was to impede her rights as a stockholder.

The Delaware Supreme Court affirmed the entire fairness determination. The Delaware Supreme Court went on, however, to hold that the trial court nonetheless erred in "bypass[ing] a different and necessary judicial review where, as here, an interested board issues stock to interfere with corporate democracy and that stock issuance entrenches the existing board." Thus, while in a vacuum the sale process and price may have been fair, "inequitable action does not become fair just because it is legally possible."

In particular, the Delaware Supreme Court held that the Court of Chancery should have assessed Coster's arguments under *Schnell* (famed for the above-quoted point that what is legally permissible is not necessarily equitable) and *Blasius Indus. v. Atlas Corp.* (which requires that a defendant provide a compelling justification for actions taken for the "primary purpose of thwarting" the stockholder franchise). Under these precedents, and notwithstanding the Court's conclusion that the transaction resulted from a fair process and produced a fair price, the Court of Chancery therefore should have cancelled the Stock Sale if (1) "the board approved the Stock Sale for inequitable reasons" or (2) if the board, acting in good faith (but without a compelling justification), "approved the Stock Sale for the primary purpose of thwarting Coster's vote to elect directors or reduce her leverage as an equal stockholder." The Supreme Court remanded for the Court of Chancery to conduct further proceedings to address these issues and, if the answer to either question is affirmative, to cancel the Stock Sale.

Coster thus serves as an important reminder that, even where a board follows an appropriate process and the result is "entirely fair" to the complaining stockholder, a court could still find that directors breached their fiduciary duties if they were motivated by inequitable reasons. It also reaffirms Delaware's commitment to the integrity of the stockholder franchise, the "ideological underpinning upon which the legitimacy of the directors managerial power rests." But *Coster* also leaves open questions. Most importantly, as the Supreme Court footnoted, how *Schnell* and *Blasius* will "fit together in future cases" with other standards of review—most importantly, *Unocal* enhanced scrutiny.

No Shortcuts Allowed: Delaware Court of Chancery Rejects Attempt to Circumvent *MFW*'s Two-Step Mandate

On June 30, 2021, the Delaware Court of Chancery largely denied defendant directors' motion to dismiss derivative claims for breaches of fiduciary duty arising from a controlling stockholder transaction. Vice Chancellor Paul Fioravanti's decision in *Berteau v. Glazek* rejected defendants' "novel" argument that the "*MFW* doctrine," set forth in *Kahn v. M & F Worldwide Corp.*, could mandate application of the business judgment rule absent a majority-of-the-minority vote and thus also serves as a reminder of the contours of the *MFW* doctrine.

The *Berteau* decision arose from a transaction that collapsed a corporate structure by eliminating an intermediate public company called SDI. Pre-transaction, SDI was a controlled, publicly traded operating company whose only material asset was a majority of the common stock of Turning Point Brands, Inc. (TPB). TPB acquired SDI to eliminate the inefficiencies inherent in an intermediate public company; TPB paid 0.97 shares of TPB common stock for each TPB share owned by SDI.

Particularly because certain members of the TPB board of directors were also directors and officers of SDI, the TPB board established a Special Committee to evaluate the transaction. The Special Committee was granted broad powers, including hiring legal and financial advisors and approving or rejecting the proposed transaction. During the negotiations, the Special Committee requested that the transaction be conditioned on a vote of TPB's minority stockholders — a vote that was not required by statute. SDI rejected this proposal, and the vote was later described as "inapplicable" due to the lack of statutory mandate. After five months of negotiations, the Special Committee determined that the proposed merger was "fair to and in the best interests of the stockholders of the Company." The merger agreement was executed on April 7, 2020, and the transaction closed in July.

The *Berteau* plaintiffs filed their derivative suit in October 2020, bringing claims against TPB's directors and controller for, among other things, breaches of fiduciary duty in connection with the transaction.

Berteau reflects the Delaware Court of Chancery's unwillingness to erode the MFW doctrine and apply the business judgment standard of review to scenarios where both protections – a special committee and a majority-of-the-minority vote – are not satisfied.

Typically, a self-dealing transaction effectuated by a controlling stockholder is subject to entire fairness review. Because the transaction was effectuated by TPB, a controlled company, and ultimately created a non-ratable benefit for the controller, the Court found that entire fairness applied, and none of the defendants "meaningfully contend[ed] otherwise."

Nevertheless, members of the Special Committee (but not the other director defendants) argued that the business judgment rule should apply pursuant to the *MFW* doctrine. The Court held that this argument "ignore[d] the history of the *MFW* doctrine and what it was intended to address."

In *MFW*, the Delaware Supreme Court held that a controlling stockholder transaction would be subject to the business judgment rule where "the merger is conditioned *ab initio* upon both the approval of an independent, adequately empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders." *MFW* thus created a pathway for controller transactions to obtain a pleading-stage, pre-discovery dismissal where (1) a special committee was formed to create a "bargaining agent who can negotiate price and address the collective action problem facing stockholders" and (2) a majority of the minority voted approvingly, thus giving stockholders the "chance to protect themselves." Because the defendants in *Berteau* had completed the transaction without a vote of TPB's minority stockholders, let alone conditioning it on their approval, the Court reasoned that *MFW*'s business judgment protection could not attach, and found no principled reason to depart from *MFW*'s dual mandate.

Berteau reflects the Court's unwillingness to erode the *MFW* doctrine and apply the business judgment standard of review to scenarios where both protections — a special committee and a majority-of-the-minority vote — are not satisfied. It is thus a reminder that those contemplating a controller-driven transaction should consider whether to seek *MFW* protection early in any deal process and discuss with counsel how best to effectuate its dual requirements.

CORPORATE GOVERNANCE DEVELOPMENTS

SEC Approves New Nasdaq Board Diversity Listing Rules

In August 2021, the SEC approved changes to the Nasdaq listing rules related to board diversity. The amended rules will require each Nasdaq-listed company, subject to certain exceptions, to:

- Publicly disclose in an aggregated form, to the extent permitted by applicable law and within one year of the August 6, 2021 approval date, information on the voluntary self-identified gender and racial characteristics and LGBTQ+ status of the company's board of directors.
- Have, or explain why it does not have, at least two directors who are diverse, including:
  - at least one director who self-identifies as female; and
  - at least one director who self-identifies as an underrepresented minority or LGBTQ+.

The board-level diversity statistics must be disclosed annually in a standardized board diversity matrix template on a company's website or in its proxy statement.

Companies will be required to have at least one diverse director within two years of the August 6, 2021 approval date and two within four to five years, depending on the size of the company and its stock market exchange tier. A Nasdaq-listed company with a board of five or fewer members will be required to have, or explain why it does not have, at least one diverse director.

For purposes of the new rules the following definitions apply:

- "Diverse" means an individual who self-identifies as a female, an underrepresented minority and/or LGBTQ+.
- "Female" means an individual who self-identifies her gender as a woman, without regard to the individual's designated sex at birth.
- "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.

SEC DEVELOPMENTS

SEC Continues to Target Cybersecurity Disclosures; New Rule Proposals Expected Soon

Through its announcement of settled charges against Pearson plc in August 2021, the SEC signaled its continued, high level of scrutiny of companies' public statements related to data security incidents. Without admitting or denying the SEC's findings, Pearson agreed to a cease and desist order (Order) and to pay a $1 million penalty. The SEC's Pearson Order follows its June 2021 announcement that it had settled charges against First American Title Insurance Company for cybersecurity disclosure control failures. Together, the Pearson and First American actions underscore the SEC's increasingly vigorous enforcement efforts on disclosure control violations related to cybersecurity issues, in particular vulnerabilities that expose sensitive customer information and data breaches.

According to the Order, Pearson learned in March 2019 that millions of rows of data had been accessed and downloaded from a company server by a threat actor exploiting an unpatched vulnerability. The software manufacturer had publicized the vulnerability as critical since September 2018, but Pearson did not implement the patch until it learned of the attack. The Order alleges that Pearson continued to use the server until July 2019—the time the server was previously scheduled to be retired. Although Pearson created an incident management team and retained a third-party consultant to investigate the breach in March 2019, Pearson determined during its investigation that it was not necessary to disclose the incident. The Order alleges that on May 7, 2019, Pearson prepared a "reactive media statement" that it intended to issue if it received a "significant media inquiry about the incident."

The Order further alleges that on July 19, 2019, Pearson provided notice of the data breach to affected individuals but did not inform school administrators that their usernames and hashed passwords were exfiltrated or that the affected accounts continued to be at risk after July 19, 2019.

On July 26, 2019, Pearson filed its Form 6-K with the SEC. The Order alleges that the filing's risk disclosure implied that Pearson faced a risk that a breach could expose confidential information but did not disclose that Pearson had, in fact, discovered such a breach months earlier. This Form 6-K filing echoed prior filings indicating that no "major data privacy or confidentiality breach" had occurred.

On July 31, 2019, approximately two weeks following Pearson's notice of the 2018 breach to affected customers, Pearson issued a statement—in response to a media inquiry—regarding the nature of the breach and the compromised data. The Order alleges that the statement incorrectly stated that "data was isolated to first name, last name, and in some instances may include date of birth and/or email address" even though usernames and hashed passwords of school personnel were exfiltrated. The statement also stated that exfiltrated data "may include" certain data such as date of birth or email addresses, when Pearson knew that approximately 50% of the exfiltrated data contained dates of birth and that a significant portion contained email addresses.

Following the filing of Pearson's Form 6-K and the posting of its media statement, Pearson engaged in an ongoing offering of its ordinary shares under the company's employee and management incentive plans. On August 1, 2019, one day after the publishing of Pearson's media statement, Pearson's stock price on the NYSE declined 3.3%.

The Order provides significant insight for public companies' disclosure regimes. Specifically, publicly traded companies should consider the following lessons as they work to improve their cybersecurity disclosure controls and programs.

1. **Assess all public statements—to regulators or otherwise—with adequate legal rigor prior to release.**

   The Order held Pearson responsible both for misleading statements made in SEC Form 6-K disclosures and for publicly available media statements. Companies should bear in mind that the SEC is focused on all communications that may affect investor decision-making when evaluating the materiality of a breach. It is vital that media notifications align with the coordinated legal response. Pearson's Form 6-K disclosure implied that no "major data privacy or confidentiality breach" had occurred despite a known intrusion discovered months earlier. The media statement also was misleading and failed to include relevant facts about the exfiltration and exposure of data the company knew was compromised.

2. **Periodically review data security protocols and procedures.**

   The SEC focused on several shortcomings in Pearson's security protocols, which led to mismanagement of personally identifiable data, continued use of the compromised server, outdated password storage, and failure to patch a known critical vulnerability. With annual, if not more frequent, review and testing of cybersecurity policies and practices, companies can protect against accusations of programmatic failings that provide opportunities on which threat actors can capitalize.

3. **Coordinate data security protection and response across business functionalities in line with assessed risk.**

   The SEC is focused not only on disclosures but also on whether companies' data privacy protection protocols align with the critical nature of stored data and actual risk of compromise. If corporate assessments indicate a significant risk of data compromise to critical business assets, data security protocols should appropriately address these risks. Those risks should be assessed across business functionalities (e.g., legal, information technology, public relations). In Pearson's case, the SEC determined that the breach at issue was material because the collection and storage of large quantities of private data on school-age children around the world was central to Pearson's business model. In fact, Pearson's Form 6-K filing even acknowledged that the company's reputation and ability to attract and retain revenue depended in part on its ability "to adequately protect personally identifiable information." In other words, the intrusion was an actualization of a significant risk that Pearson itself acknowledged in its Form 6-K.

The SEC is considering enhancing its disclosure rules concerning cybersecurity risk governance and has indicated a target release date of October 2021 for rule proposals.

As noted our Sidley Update on the First American action, the SEC is considering enhancing its disclosure rules concerning cybersecurity risk governance and has indicated a target release date of October 2021 for rule proposals.[12]

SIDLEY RESOURCES

M&A Litigation

A Delaware Corporate and M&A Checklist: 11 Cases That Every Practitioner Should Know (August 30, 2021). This post on Sidley's Enhanced Scrutiny blog summarizes the bedrock decisions of modern Delaware M&A practice and highlights 11 key decisions with which every practitioner should be familiar.

Shareholder Activism

SPACs: A New Frontier for Shareholder Activism. Sidley partners Derek Zaba, Kai Liekefett and Joshua DuClos published an article in NIRI's *IR Update* discussing how the SPAC boom has created a new breeding ground for activism targets and how SPACs should prepare for an activist attack.

A Wake-Up Call Not Only for Big Oil: The Intersection of Economic Activism and ESG. Sidley partners Derek Zaba and Kai Liekefett recently wrote an article in *The Ethical Boardroom* regarding the intersection of economic activism and ESG. As ESG themes are becoming important to investors, they have transformed into powerful campaign tools for economic activists who seek to make changes to the composition of public company boards. Recent triumphs reflect the growing and effective pressure that investors are exerting on public companies.

Corporate Governance; ESG

Oversight of EESG Disclosure. In an article published in the August/September 2021 edition of Practical Law's *The Governance Counselor*, Holly J. Gregory, a partner in Sidley's New York office, explores the board's role in disclosure about employee, environmental, social

12 See Cybersecurity Risk Governance, 3235-AM89, Securities and Exchange Commission (Spring 2021); SEC Announces Settled Charges Against First American for Cybersecurity Disclosure Controls Failures – Lessons Learned, Sidley Austin LLP (June 24, 2021) (discussing the SEC's February 26, 2018, Commission Statement and Guidance on Public Company Cybersecurity Disclosures). See also SEC Issues New Guidance on Cybersecurity Disclosure Requirements, Sidley Austin LLP (Mar. 2, 2018).

and governance (EESG) issues and reviews key developments with respect to mandated and voluntary disclosure.

Sidley lawyers Holly J. Gregory, Leonard Wood and Rebecca Grapsas recently wrote the U.S. chapter of the inaugural *Getting the Deal Through — ESG & Impact Investing*. The comparative summary addresses various ESG topics, including impact investing, purpose-driven companies, impact measurement standards, policies and tax incentives.

SEC Enforcement

Implications of SEC's Recent Insider Trading Enforcement Action in SEC v. Matthew Panuwat (August 25, 2021). On August 17, the SEC filed a litigated complaint against a former employee of a biopharmaceutical company for trading in a peer company's stock in advance of an announced acquisition of his employer. The SEC's complaint alleges that — minutes after learning that his company would be imminently acquired and days before the news was publicly announced — the employee purchased short-term, out-of-the-money stock options of the peer company (sometimes referred to as an "economically-linked" company) whose value he anticipated would materially increase upon the announcement. The SEC alleges that the employee traded based on material non-public information he learned in the course of his employment and in breach of a duty of confidentiality to his employer.

This action serves as a reminder that the SEC is willing to apply theories of insider trading and the element of materiality to novel fact patterns. Here, that means bringing charges where an insider trades in securities of a company that is neither the entity to which the duty of trust and confidence was owed, nor a company potentially involved with that entity (such as a merger target), but a company that is somehow economically linked, such as a peer or competitor company. This Sidley Update suggests steps for companies and fund managers to consider in the wake of this recent enforcement action, including reviewing policies and procedures and conducting updated employee training to address risks associated with trading securities of economically-linked companies.

National Beverage Corp. and the SEC's Ongoing Scrutiny of Executive Perquisites and Benefits (August 9, 2021). On August 4, the SEC announced settled charges against National Beverage Corp. relating to its failure to disclose executive perquisites provided to its CEO. The SEC's fifth perquisite case in a little over a year, this settlement signals the Commission's continued focus on undisclosed perks, a priority articulated in 2020. This Sidley Update highlights four key takeaways for public companies and their officials.

Labor and Employment

The Next Wave: Legal and Practical Considerations for Employers Regarding COVID-19 Vaccinations (September 7, 2021). Following the recent U.S. Food and Drug Administration approval of one COVID-19 vaccine, spiking cases due to the Delta variant, and a notable uptick in vaccine mandates by businesses, state and local authorities and educational institutions, many employers that have yet to mandate are left wondering whether or when they should do so. This Sidley Update discusses recent developments to federal and state laws and guidance as well as practical considerations that employers may want to keep in mind before changing or setting their COVID-19 vaccine policies.

Foreign Investment

Recent and Upcoming Investment Screening Reforms in the European Union (September 13, 2021). Investment screening has increasingly become a critical part of deal making. Countries across the globe have adopted or expanded, or are in the process of adopting or expanding, regimes for reviewing inward investments for national security and/or public order concerns. Most of these regimes impose preclosing approvals, or foresee potential ex-post reviews, for a wide range of deals. Investors and sellers must be cognizant of these regimes and the associated (1) effect on deal timing and potential (retroactive) conditionality of approvals (or prohibitions) and (2) potentially severe consequences for failing to comply with applicable restrictions. This Sidley Update provides an overview of recent and upcoming reforms in the European Union, which will need to be taken into account as part of international transactions. For further information, see Sidley's investment screening website.

SIDLEY EVENTS

Sidley Corporate College

October 13-15 | Virtual

Sidley will host its annual Corporate College virtually on October 13-15. Sidley's Corporate College is a three-day training program intended to expose participants to a broad spectrum of topics that a transactional lawyer is likely to encounter. Presentation topics will include M&A, private equity, shareholder activism, capital markets, corporate governance, SEC enforcement and hot topics, bank financing, tax structures in M&A transactions, cross-border M&A and ethics. In-house lawyers of all levels may benefit from the program. Anyone interested in attending should contact chevents@sidley.com.

SIDLEY SPEAKERS

PLI Institute on Securities Regulation

November 3-5 | New York or Webcast

Sonia Gupta Barros, a partner in Sidley's Washington, D.C. office, will participate in a panel titled *Disclosure Developments for Public Companies* at the Practising Law Institute's 53rd Annual Institute on Securities Regulation on November 4. Click here for more information.

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