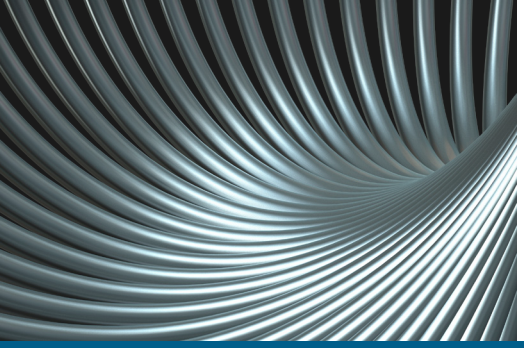

Sidley Perspectives

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SIDLEY

ANALYSIS

A BOARD'S GUIDE TO OVERSIGHT OF ESG

By Katie LaVoy[1]

The past few years have brought significant attention to environmental, social and governance (ESG) principles, whether related to climate change, sustainability, human capital management or diversity, equity and inclusion. As boards of directors consider their risk management and oversight responsibilities, what weight should they give ESG issues?

Caremark and subsequent cases establish that directors may be held liable under the duty of loyalty for a failure of oversight if (1) directors "failed to implement any reporting or information system or controls" or (2) despite such a system or controls, the directors "consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention."[2] Thus, the board's fiduciary duties require that it exercise oversight—within its informed, good faith discretion—of the company's strategy and "mission-critical" risks in pursuit of long-term value, including by implementing and monitoring an effective compliance program and related system of controls.[3]

Are ESG Issues and Opportunities "Mission-Critical"?

Leo Strine, former Chief Justice of the Delaware Supreme Court, recently advocated for consideration of employee, environmental, social and governance factors as interconnected to the board's duty to monitor ordinary compliance.[4] Certainly, a recitation of board duties and responsibilities typically includes topics such as corporate strategy, financial integrity, risk oversight and oversight of key executives. With the individual topics of E[nvironmental], S[ocial] and G[overnance] covering such a broad range of topics, it is difficult to disagree with the conclusion that every company will need to consider some elements of ESG to be mission-critical. For example, within these broad topic areas lie many board-level responsibilities that fit unequivocally under the ESG umbrella, such as CEO succession and compensation, talent development and compliance with environmental and safety laws and regulations. Ignoring elements of ESG risk or failing to implement information systems and controls that allow board consideration of these types of ESG topics may indeed be the kind of failure that would sustain a *Caremark* claim.

Ignoring elements of ESG risk or failing to implement information systems and controls that allow board consideration of these types of ESG topics may indeed be the kind of failure that would sustain a Caremark *claim.*

Based on the flurry of ESG-related pronouncements and proposed rule-making the Securities and Exchange Commission (SEC) has engaged in over the last several years, it would appear that the SEC agrees and considers elements of ESG to rise to the level of mission-critical risk. For example, the SEC's proposed rule on climate related-disclosures would require that public companies describe the board's oversight and governance of climate-related risks, including (1) identification of the committee or directors responsible for climate-related risk oversight and whether any director has climate-related risk expertise, (2) the processes by which the board or committees discuss climate-related risks, including how the board is informed of climate-related risks and the frequency of such discussions, (3) whether and how the board or committee considers climate-related risks as part of business strategy, risk management and financial oversight and (4) whether and how the board or committee sets and oversees progress against climate-related targets or goals.[5] If the rules

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2 *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) and *Stone v. Ritter*, 911 A.3d 362 (Del. 2006).

3 *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019).

4 Leo E. Strine, Jr. et al., *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, 106 Iowa L. Rev. 1885 (2021).

5 The SEC's proposed rule on *The Enhancement and Standardization of Climate-Related Disclosures for Investors* is available here and summarized in the Sidley Update available here.

are enacted as proposed, boards will have to evaluate whether their current governance processes over climate-related risk are sufficiently robust or should be enhanced in anticipation of the required disclosures.

In addition, in March 2021, the SEC announced the formation of a Climate and ESG Task Force focused on identifying material omissions or misstatements in issuers' ESG disclosures, and in April 2022, the SEC filed its first ESG-related enforcement action against Vale S.A., a publicly traded mining company based in Brazil. The charges relate to fraudulent statements made by Vale related to dam safety and stability leading up to the collapse of Vale's Brumadinho dam, as discussed in the Sidley Update available here. While the Vale complaint appears to be the first SEC action based in part on disclosures made in publicly available ESG or sustainability reports, the complaint follows a fairly typical format of alleging that Vale made false or misleading disclosures about the safety of its products or facilities. Nonetheless, public company boards should expect that the SEC and its Climate and ESG Task Force will scrutinize a company's ESG disclosures for misrepresentations or omissions after a product or facility has caused environmental or social harm. Moreover, as part of the Climate and ESG Task Force's mission is to proactively seek out material misstatements and disclosure gaps, companies may be subject to inquiry by the Climate and ESG Task Force before any actual physical harm has occurred. Boards must therefore ensure that processes and controls exist to confirm the accuracy of disclosures, be on guard for material omissions and maintain sufficient documentation to validate representations related to environmental and other ESG-related issues, whether they are published in filed disclosure or publicly available reports to shareholders and stakeholders, such as ESG or sustainability reports.

Boards must decide which elements of ESG are mission-critical and tailor board processes to ensure that oversight of those particular elements is integrated into board operations, or else be subject to an inference that it deliberately shielded itself from its oversight responsibilities.

The protection of the business judgment rule provides boards with flexibility, however, to consider which elements of ESG are relevant to company operations. The important point here is that boards must actually consider and decide which elements of ESG are mission-critical and tailor board processes to ensure that oversight of those particular elements is integrated into board operations, or else be subject to an inference that it deliberately shielded itself from its oversight responsibilities. Boards should take caution, however, not to consider the entirety of "E and S and G" as mission-critical, which would dilute the importance of truly high-priority and essential subject matters.

Are ESG Issues and Opportunities of Strategic Importance?

Setting aside momentarily the question of whether a board has a legal obligation to enable processes to monitor and govern elements of ESG risk, boards may have other reasons to elevate ESG risk. Boards should consider good ESG governance an element of strategic importance—to attract customers, investors and employees or as an opportunity for growth.

A powerful and growing group of investors believes ESG risk is strategically important. Investors incorporate ESG elements into investment decisions and stewardship, viewing ESG as a means of generating long-term value and focusing on disclosure and compliance with reporting standards such as the Sustainability Accounting Standards Board and the Task Force on Climate-Related Financial Disclosures. Larry Fink, Chairman and CEO of BlackRock, explains his attention to ESG disclosure, practices and policies as a critical element of strategy: "Stakeholder capitalism is all about delivering long-term, durable returns for shareholders. And transparency around your company's planning for a net-zero world is an important element of that … As stewards of our clients' capital, we ask businesses to demonstrate how they're going to deliver on their responsibility to shareholders, including through sound environmental, social, and governance practices and policies."[6]

An examination of the top 10 institutional investors by assets under management reveals that these investors broadly acknowledge that ESG is important in maximizing long-term

6 Larry Fink's 2022 Letter to CEOs: *The Power of Capitalism*, available here.

shareholder value and expect and encourage annual reporting on ESG matters, including sustainability policies and strategy. While some institutions are more prescriptive in expressing expectations regarding disclosure on ESG-related issues and may have particular metrics in mind, others look just to obtain an understanding of the impact of ESG risks on the public company's business. Institutional investors also perceive ESG matters as not only potentially value-destructive (such as with risks) but value-enhancing as well (such as with opportunities for growth and differentiation). As a result of increased investor focus, boards of directors should consider good ESG governance, at a minimum, an element of investor relations best practices.

Key constituents other than investors, such as employees, also focus on elements of ESG and expect boards to have ESG competence. In this era of talent competition, potential employees may seek employers with superior talent management programs and social impact—both elements of a solid "S" strategy—as well as commitment to sustainability practices and other climate-related goals. Current employees are also demanding more from their employers in the form of better working conditions and more flexible working arrangements which, when combined with a tight labor market, have led to high-profile unionization efforts at Amazon and Starbucks. The practical implications of this organizing success further strengthen the need for board oversight of a holistic human capital management strategy.

Customers, another important stakeholder group, may focus on brands' social impacts in purchasing decisions and further consider a company's adoption of sustainability practices as a differentiating element. A company's efforts to increase both workforce and supplier diversity may be a key decision-making point for both potential employees and customers. Appropriate and accurate disclosure of these programs and initiatives (and the avoidance of misstatements, critical omissions and "greenwashing") should be an area of active oversight by boards.

Integrating Oversight of ESG Risk Into Board Processes

Effective board oversight necessitates understanding how ESG factors into business decisions, including strategic decisions, risk assessments and enterprise risk management.

Effective board oversight necessitates understanding how ESG factors into business decisions, including strategic decisions, risk assessments and enterprise risk management. The board should determine how to incorporate ESG into long-term strategy and risk management and who in management has responsibility for ESG decision-making. The business judgment rule affords boards significant discretion in tailoring oversight of ESG matters to their companies' particular businesses, and boards may delegate oversight authority to one or more committees.

With these principles in mind, boards of directors should tackle oversight of ESG risks as they would any other risk. First, boards and management should identify which elements of ESG are relevant and could rise to a level of "mission-critical" risk to the company, whether now or in the foreseeable future. This exercise may be accomplished through the company's regular enterprise risk management processes and should include development of a process for identifying and reporting on those risks to the board.

Second, given the breadth of topics covered by ESG, boards should divide the various elements of ESG risk among its various committees or create a standalone ESG committee.[7] Companies often delegate ESG oversight to the nominating and governance committee, although oversight involving disclosure metrics is often delegated to the audit committee and human capital matters may be delegated to the compensation committee. Even when delegated, however, at the board level, directors should regularly discuss ESG as a component of the company's long-term strategy and risk management.

7 Indeed, some institutional investors have specifically requested that boards create standalone committees designed to address ESG or sustainability issues. See, e.g., JPMorgan Asset Management, *Corporate Governance Principles* and *Proxy Voting Guidelines* (p. 16); UBS Asset Management, *Proxy Voting Summary Policy & Procedures* (p. 10).

For example, consider a board that has three committees: Audit, Compensation and Nominating and Governance. After considering the various risks that are relevant and important to the company, the board may amend the charters of the various committees as follows:

- Audit Committee: include responsibility for review of ESG impacts on overall risk management, responsibility for review of the quality of the company's internal controls to ensure disclosures are accurate and oversight of assurance or attestation, if any
- Compensation Committee: include oversight of human capital management, talent development and diversity, equity and inclusion initiatives and incorporation of ESG performance metrics into short- and long-term executive compensation incentives
- Nominating and Governance Committee: include general oversight of "E" and "S" in addition to "G" and consideration of ESG or sustainability experience in director qualifications and board composition

A board might further consider whether to amend its corporate governance guidelines to require best practices benchmarking of ESG-focused practices, risk oversight and disclosure as compared against peer practices, institutional investor guidelines and rating agency criteria.

The board should ensure that division of responsibility for ESG matters and execution of those duties is documented appropriately through regular board agenda items and explicitly address ESG responsibilities in governance guidelines or committee charters.

Finally, the board should ensure that division of responsibility for ESG matters and execution of those duties is documented appropriately through regular board agenda items and explicitly address ESG responsibilities in governance guidelines or committee charters. As a final step in discharging those duties, the board should ensure that minutes of meetings reflect both the report of information on ESG topics and directors' consideration of current and future issues and risks. Minutes should further reflect when the board discusses or receives reports on the remediation of any previously identified ESG issues to show proper oversight of management.

If the "carrot" of good governance and responsiveness to stakeholders is not enough to galvanize boards to monitor ESG risk, boards should consider the proverbial "stick." Boards that do not meet investor expectations regarding ESG disclosures, policies and practices may find themselves the subjects of "vote against" campaigns and may face increasing numbers of shareholder proposals on ESG issues.[8] Perhaps more critically, the U.S. Sentencing Guidelines reward companies with effective ethics and compliance programs with reduced consequences and explicitly require that the "governing members" of the organization (e.g., the board of directors) "exercise reasonable oversight with respect to the implementation and effectiveness" of compliance and ethics programs.[9] Integration of ESG risks and potential issues into the board's oversight of risk and compliance programming thus benefits the company from the perspective of good governance as well as a potential reduction in liability should one of those risks become reality.

8 See, e.g., BlackRock Investment Stewardship, *Proxy voting guidelines for U.S. securities* (pp. 17-18); State Street Global Advisors, *Guidance on Climate-Related Disclosures* (pg. 4).

9 United States Sentencing Guidelines, §8B2.1.

THE DEAL CLOSED—NOW WHAT? PRACTICAL CONSIDERATIONS FOR SPONSORS AND MANAGEMENT TEAMS OF NEWLY ACQUIRED PRIVATE EQUITY PORTFOLIO COMPANIES

By Jessica M. Day and Roger R. Wilen [10]

Following an acquisition by a private equity sponsor, there are certain operational matters that should be addressed to set up both the sponsor and the management team for a successful relationship.

What a relief—your months of hard work have paid off and the deal has closed. Time to begin implementing the strategies that will make this new investment a success, right? Not so fast. Following an acquisition by a private equity sponsor, certain operational matters should be addressed to set up both the sponsor and the management team for a successful relationship. Below is a checklist of items a new private equity portfolio company should consider before diving into the operation of the business.

1. Don't lose sight of obligations agreed to in the transaction documents.

Just because the transaction closed does not mean your obligations under the acquisition agreement have concluded.

- **Summarize post-closing obligations.** One important (but often overlooked) post-closing task is to prepare a simple summary (with corresponding calendar reminders) of obligations under the transaction documents that continue beyond the closing. This is of particular importance in transactions involving earnouts and any reporting obligations or operating covenants in connection therewith. Additionally, if the acquisition agreement includes a right to indemnification, make note of the time periods during which you are able to bring a claim.
- **Prepare the working capital statement.** For a buyer, one of the most notable post-closing obligations will be the preparation of the working capital statement, which is typically required to be delivered within 45 to 90 days following the closing.
- **Attend to R&W binding tasks.** Also critical are the post-closing tasks specified in the representation and warranty (R&W) insurance policy. In addition to delivering a copy of the virtual data room, one of the primary requirements is delivery of the final transaction documents, which is all the more reason to ensure that compilation of final versions is not overlooked.

2. Attend to administrative matters.

For each acquisition, it is important to confirm that someone within your organization (or your outside counsel) is responsible for addressing certain administrative matters immediately following the closing.

- **Request return of confidential information.** Even if not presented as a competitive auction process, it is important to request from the sell-side (including the investment banker) any confidentiality agreements entered into between the acquired company (the company) and other potential acquirers, as any such confidentiality agreements are assets of the company that may need to be enforced down the road. Depending on the terms of such confidentiality agreements, the investment banker should contact each potential acquirer to request the return or destruction of the company's confidential information.
- **Retain a copy of the VDR.** Retain a copy of the virtual data room (VDR) used in connection with the transaction in a format that will be easily accessible in the future (if possible, best to save directly to a shared document management system with no size limitations or expiration periods). Not only will a copy of the VDR be required for the representation and warranty insurer, but it may also prove beneficial to maintain a record of the information provided by the sell-side in connection with the transaction.
- **Implement desired governance structure.** Establish the desired go-forward director and officer slate across all subsidiaries. For the acquired companies, adopt new organizational

10 Jessica M. Day is a senior managing associate in Sidley's Chicago office who advises clients on M&A, private equity transactions and corporate governance matters. Roger R. Wilen is a partner in Sidley's Chicago office whose practice focuses on private equity. The views expressed in this article are those of the authors and do not necessarily reflect the views of the firm, its other lawyers or its clients.

documents (including charters, bylaws and LLC operating agreements, as applicable) to align with the sponsor's desired governance structure. Though note, if entering into a new credit facility in connection with the transaction, it is often preferable for the organizational documents of any borrower entities to be reviewed prior to and adopted at closing. For purposes of operational efficiency and also engendering goodwill, it can be helpful to retain the roles of certain members of the pre-closing management team. However, unless otherwise negotiated, the board of directors (or similar governing body, the board) will be comprised of a majority of the sponsor's appointees.

- **Update the registered agent.** Consider whether it makes sense to update the registered agent to use the same service provider not only across all company subsidiaries, but also across different platforms. Regardless, the company contact persons should be updated to those of the buyer and its counsel so notices do not go to the wrong addressee.
- **Review small or minority-owned business status.** If the company was previously receiving benefits as a small or minority-owned business, take affirmative steps to update any government filings to the contrary.
- **Address issues identified in diligence.** Take time to rectify deficiencies identified during due diligence, such as employment matters, labeling law requirements or appropriate data security procedures.
- **Manage intellectual property portfolio.** If the company has registered intellectual property, make sure there is a proper handoff to new counsel so deadlines, etc. are not missed.

Given the number of operational changes that will take place immediately following the closing, clearly identifying and communicating each person's role and responsibilities will be key.

3. Familiarize the team with the go-forward operating procedures.

Given the number of operational changes that will take place immediately following the closing, clearly identifying and communicating each person's role and responsibilities will be key.

- **Summarize go-forward obligations.** Similar to the post-closing obligations under the transaction documents, it can be helpful to prepare and share a summary of the restrictions imposed by the organizational and financing arrangements implemented in connection with the closing. Consider using the summary as a template that can be updated as the platform evolves, new add-on acquisitions are made, the credit agreement is amended and new co-investors or management members are added to the cap table.
- **Understand procedural requirements.** When communicating information or seeking approvals, ensure that all procedural requirements contained in the company's organizational documents are being respected, such as timing requirements for calling a special meeting of the board or shareholders, and providing copies of written consents to all members of the board and, as appropriate, those with board observer rights.
- **Focus on rights of minority investors.** If minority protections have been negotiated with co-investors, such as the right to consent to certain transactions or the incurrence of indebtedness over an agreed-upon threshold, make sure management knows the limitations placed on its ability to make decisions unilaterally.
- **Identify obligations under the credit agreement.** Similarly, a new platform acquisition will often mean a new credit facility with new covenants. Early on, establish a culture to avoid making decisions without consulting the credit agreement—oftentimes, lender consent will be required prior to forming a new subsidiary or entering into a new lease.

4. Align expectations with the board.

Following an acquisition, the active role taken by the board may require a change of mindset for a management team unfamiliar with such a structure. As such, it is important to establish from the outset the expectations of the board and the obligations of management.

- **Engage an accounting firm.** The sponsor may wish to utilize its typical accounting firm for the preparation of the portfolio company's financial statements. In some cases, if the portfolio company has not previously prepared audited financials, the process for doing so will need to be established.
- **Understand key performance indicators (KPIs).** Beyond audited financials, the board may want to track specific metrics. Similarly, the accountants and management team should implement procedures for regular tracking.
- **Establish reporting expectations.** Upon acquisition, the board should clearly communicate expectations for the information sharing process. Typically, the expectation will be for quarterly board meetings (though again, it is important to understand the terms of the go-forward organizational documents as well as the financing arrangements, as the obligation to deliver financials to the lenders, as well as other minority investors or even board observers, will often drive the reporting process). Board meetings will be when management processes all of the new reporting information and presents it to the board and the teams iterate on how best to capture company progress.

5. Be ready to sell!

Because future add-ons and an eventual exit are all but inevitable, maintaining good corporate hygiene will make the process less disruptive when the time comes.

It may seem counterintuitive that one of the first steps post-acquisition is to prepare for a sale, but the private equity business model requires it. If not addressed in connection with the acquisition, incentives for all parties should be aligned to realize a return on an eventual exit. Management should be informed of the sponsor's goals for the investment, including the potential holding period and probable exit strategies. Because future add-ons and an eventual exit are all but inevitable, maintaining good corporate hygiene will make the process less disruptive when the time comes.

- **Keep organizational matters organized.** Make sure someone is responsible for maintaining the company's books and records so that the company's corporate history (including entity structure, capitalization table, directors and officers, etc.) is easy to follow and readily available for purposes of a future due diligence review. The importance compounds with each additional add-on acquisition.
- **Avoid restrictive provisions.** Portfolio companies should be advised to try to avoid confidentiality provisions in their commercial contracts (or provide a carve-out that allows for disclosure to new investors or purchasers), as this can become problematic for information sharing with a potential future acquirer. Similarly, when agreeing to restrictive covenants in commercial contracts (e.g., non-competes, non-solicits, exclusivity), portfolio companies need to be vigilant to avoid provisions that could potentially bind affiliates or other upstream entities.
- **Avoid entering into contracts with the parent holding company.** The parent company into which all equity is contributed is typically a mere holding company with no intended operations. The management team should be forewarned that under no circumstances should contracts be entered in the name of that entity.
- **Create communication channels.** Important for any company but particularly one contemplating a future sale, all parties should be cognizant that email may not be the best method for initially communicating sensitive information because following an acquisition, the acquirer will have access to the company's email servers.

Following these steps will hopefully lead to a smooth transition and greater future success for all constituencies of a newly acquired private equity portfolio company.

UK MERGER CONTROL: CMA'S TOUGH APPROACH; CHANGES TO THRESHOLDS AFOOT

By Patrick Harrison and Bethany Wise[11]

The UK should be considered alongside larger jurisdictions such as the U.S. and EU, and as early as possible in the process, when considering the antitrust implications of cross-border transactions.

With the UK having left the European Union, the UK's Competition and Markets Authority (CMA) now has the ability to review multinational deals that the European Commission (Commission) would previously have reviewed on its behalf. There are already suggestions of material divergence between the CMA and other agencies, with the CMA appearing to take a tougher approach.

Recent examples include:

- *NortonLifeLock Inc./Avast:* NortonLifeLock announced its proposed $8 billion acquisition of Avast in August 2021. The proposed transaction received swift unconditional clearances in the U.S., Germany and Spain but the CMA has referred the transaction to an in-depth Phase II investigation, which is set to run until September 2022.
- *Cargotec/Konecranes:* Cargotec announced its proposed $5 billion acquisition of Konecranes in October 2020. The proposed transaction was notified to a number of competition authorities, including the CMA and the Commission. The Commission granted conditional clearance in February 2022, but the CMA prohibited the transaction in March 2022, considering the remedies package agreed with the Commission to be inadequate. Shortly after the CMA's prohibition decision, the parties announced that they had abandoned the proposed deal.

There are also recent examples of the CMA taking a less aggressive stance than other regulators. In January 2022, the CMA unconditionally approved Meta's $1 billion acquisition of Kustomer following a Phase I review, whereas the Commission initiated an in-depth Phase II review of the deal and granted conditional approval only after Meta agreed to long-term behavioral remedies.

Nonetheless, the general trend taking shape appears to be that the CMA is pursuing a more hawkish stance in its review of proposed transactions.

Reform of Jurisdictional Thresholds

On April 20, 2022, the UK government announced significant reforms to the UK competition and consumer law frameworks. One of the key changes in merger control will be the introduction of new jurisdictional thresholds as the CMA seeks to bring so-called killer acquisitions within scope of the UK regime.

Under the existing jurisdictional thresholds, a proposed transaction will fall within the scope of the UK merger control regime where: (1) the parties' activities overlap and their combined share of supply exceeds 25% and (2) the target's UK turnover exceeds £70 million.

The new proposed thresholds expand CMA jurisdiction by allowing the CMA to review proposed transactions with a "UK nexus" (yet to be defined) where the buyer has both (1) an existing share of supply in the UK of 33% or more and (2) UK turnover in excess of £350 million. As a result, transactions involving a large buyer will be captured even where the parties do not have overlapping activities in the UK.

The government is yet to indicate the timing for the proposed reforms to enter into effect.

Key Takeaways

Moving forward, the UK should be considered alongside larger jurisdictions such as the U.S. and EU, and as early as possible in the process, when considering the antitrust implications of cross-border transactions.

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Even before the UK's new jurisdictional thresholds formally take effect, parties should consider very carefully whether the CMA could assert jurisdiction over deals, including by taking an expansive approach to its existing "share of supply" test.

NEWS[12]

JUDICIAL DEVELOPMENTS

Delaware Chancery Court Denies Motions to Dismiss Claims That an Activist Fund's Board Rep Fast-Tracked Sale to Maximize Insider Trading Profits

The Delaware Chancery Court in Goldstein v. Denner: *"[i]t is reasonably conceivable that Denner's conflicts tainted the sale process from the jump and that he steered the Company toward a quick sale to Sanofi to serve his own interests in maximizing his short-term profits from insider trading at the expense of generating greater value through a competitive bidding process or by having the Company remain independent."*

The Delaware Chancery Court recently denied motions to dismiss claims alleging that directors and officers of Bioverativ Inc. (the Company) breached their fiduciary duties in connection with the sale of the Company to Sanofi S.A. *Goldstein v. Denner* (May 26, 2022). Evaluating the sale process under enhanced scrutiny, the Court found that it was reasonably conceivable that a conflicted director "steered the Company toward a quick sale to Sanofi to serve his own interests in maximizing his short-term profits from insider trading at the expense of generating greater value through a competitive bidding process or by having the Company remain independent."

A global biotech company spun off Bioverativ as an independent publicly-traded biotech company in February 2017. In May 2017, Sanofi approached two Bioverativ directors—Alexander Denner and Brian Posner—to express interest in acquiring the Company for approximately $90 per share, a 64% premium over the then-current market price. They told Sanofi the Company was not for sale but did not disclose Sanofi's outreach to the rest of the board. Days later, Denner allegedly directed hedge fund entities he controlled—collectively referred to as Sarissa—to purchase 1,010,000 shares of Bioverativ's stock at prices in the mid-$50s per share, resulting in Denner and Sarissa increasing their aggregate holdings eightfold. The purchases violated the Company's insider trading policy and were not disclosed to the rest of the board.

To avoid triggering Section 16(b) of the Securities Exchange Act of 1934, which requires an insider to disgorge short-swing profits from any sale that occurs within six months of purchase, Denner and Posner allegedly delayed engagement with Sanofi about the sale. When Sanofi followed up in June 2017 and September 2017, they reiterated that the Company was not for sale. However, when Sanofi reached out in October 2017 when the Section 16 disgorgement period was about to expire, Denner "acted unilaterally to put the Company in play." Without informing the board or obtaining board approval, he invited Sanofi to make a bid at a "'preemptive' price, i.e., a price that is sufficiently high that it would obviate the need for a pre-signing market check" that could lead to a single-bidder process to acquire the Company.

So as not to jeopardize the tax-free nature of the spinoff and trigger a substantial indemnification payment, the Company could not pursue a deal with any buyer that had discussed a potential transaction with Bioverativ's former parent company prior to the spinoff until February 2019. This restriction kept the board from engaging with the most likely acquirors, and delaying the sale process until after the restriction period expired could have led to a higher deal price.

In November 2017, Sanofi offered to acquire the Company for $98.50 per share. This was the first time the full board learned of Sanofi's interest. Following negotiations, Sanofi and the

12 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Elizabeth Y. Austin, Jim Ducayet, Lia M. Higgins, Claire H. Holland, Galit A. Knotz, Wendy M. Lazerson, Jon Muenz, Mark C. Priebe, Katherine A. Roberts and Marlow Svatek. We also acknowledge the contributions of summer associates Jack N. Cadden, Kathy Jara, Taylor J. Wilson and Rachel B. Zingg. 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.

Company agreed to a price of $105 per share, which was almost one-third below a standalone valuation by the Company's management team and financial advisors of more than $150 per share under its long-range plan. To justify the disconnect between the valuation and deal price, the management slashed the Company's projections after discussions with the board, including by reducing projected revenue by $23.7 billion, even though no new information had come to light. The Company's financial advisors relied on these lower projections to deliver their fairness opinions at the January 2018 meeting when the board voted to approve the merger agreement. The transaction closed in March 2018, generating a $49.7 million profit for Denner and Sarissa from their brief investment in the Company.

A stockholder plaintiff filed suit alleging that certain Company directors and officers breached their fiduciary duties by (1) failing to make requisite disclosures, (2) approving, falsifying and omitting material information from key documents related to the transaction and (3) failing to secure the highest value for the Company's stockholders, including by favoring their own self-interest above those of other stockholders. On May 26, 2022, Vice Chancellor J. Travis Laster denied dismissal of the disclosure and sale process claims.

The Delaware Chancery Court held that the Corwin *doctrine was not available to cleanse the challenged transaction because the plaintiff adequately pled multiple disclosure deficiencies which made it reasonably conceivable that approval by the disinterested stockholders was not fully informed.*

The Court found that the plaintiff sufficiently pled that the transaction did not yield the best value reasonably available to the stockholders due to the flawed sale process, specifically the combination of (1) Denner's insider trading, (2) Denner's invitation to Sanofi shortly before the expiration of the Section 16 disgorgement period to engage in a single-bidder process, (3) Denner's role in agreeing to a price of $105 per share, (4) the disconnect between the deal price and the valuation data available to the board and (5) the downward revisions to the projections to justify a sale price that undervalued the Company.

The complaint further charged that Denner engaged in insider trading and that Sarissa aided and abetted this breach of fiduciary duty. On June 2, 2022, Laster denied dismissal of these counts, writing that at the current stage of litigation, it was "reasonable to infer" that Denner acted on material information when he directed Sarissa to purchase 1,010,000 shares of Company stock.

The *Goldstein* opinion may also signal increased scrutiny of the independence of directors repeatedly placed on boards by activist investors. Of particular note is the Court's focus on whether the directors acted independently of Denner in authorizing the transaction. Delaware law has long held that a director may lack independence due to a sense of gratitude for past benefits conferred. Recent scholarship indicates that the same may be true when a director is promised future benefits. The Court explained that the receipt of past directorships and access to a steady flow of future board opportunities—such as those generated and secured by activist investors—may be sufficient to compromise a director's independence: "Although a director's nomination to a board standing alone is not enough to call into question the director's independence from the nominating party, a pattern of facts surrounding the director's service can do the trick."

The plaintiff alleges that four directors were beholden to Denner and, as such, were not independent from him. The Court quickly rejected the claim that one director was obligated to Denner merely because (1) both defendants served on Bioverativ's former parent company's board since 2009, (2) they were both placed on that board by activist investor Carl Icahn and (3) Icahn previously nominated the board member to the board of Yahoo!. The Court likewise rejected the scant claim that another director lacked independence from Denner because, after the Sanofi transaction, Denner appointed him to serve on the board of a special purpose acquisition company affiliated with Sarissa.

But other director independence allegations presented a "close call." One director had previously supported and financially benefited from a similar transaction Denner had orchestrated. Less than two weeks later, Denner appointed that same director to Bioverativ's board. The Court held that although "not overwhelming," when viewed in tandem with

Denner's "practice of rewarding directors with lucrative directorships on other Sarissa-affiliated boards" and the allegedly dubious sale terms, the allegations were sufficient to support a reasonable inference that the director was not acting independently of Denner in supporting the deal. Similarly, the Court ruled that it was reasonably conceivable that a director who was unemployed prior to Denner's securing him a seat on the Bioverativ board, and who was also placed on an additional board by Denner which resulted in a $3 million gain, was not independent. Thus, the Court ultimately found that a majority of the six-person board, including Denner, was either potentially interested in the transaction or lacked independence in deciding to approve the merger.

Although the Court held that these facts allowed the plaintiff's non-exculpated claims against certain directors to survive the pleading stage, the opinion also emphasized that: "Outside of a Rule 12(b)(6) motion in a case governed by enhanced scrutiny, it is unlikely that a similar constellation of facts would be sufficient to overcome the presumption of good faith or to call a director's independence into question … Nor is it clear that the same constellation of facts would render [the director] non-independent for purposes of rebutting the business judgment rule and causing entire fairness to apply."

The general principles regarding independence and the fact-specific approach taken to evaluate independence are longstanding tenets of Delaware law. However, the application of these principles to directors repeatedly placed on boards by activist investors is less common and may be cited in future cases involving activist investors who engage in repeat director appointments.

All Roads Lead to Fair Price: The *Tesla* Decision

The Delaware Chancery Court's recent post-trial decision in *In re Tesla Motors, Inc. Stockholder Litigation*, C.A. No. 12711-VCS (Apr. 27, 2022) includes a helpful discussion of the importance of fair price when analyzing a transaction under the entire fairness analysis. There, Tesla stockholders brought claims against members of Tesla's board of directors and Tesla's CEO and controlling stockholder, Elon Musk, related to Tesla's acquisition of SolarCity Corporation. The *Tesla* plaintiffs alleged that controlling stockholder Musk "caused Tesla's servile Board to approve the Acquisition of an insolvent SolarCity at a patently unfair price, following a highly flawed process." After a trial, the Court found that Musk and numerous other members of the Tesla board were conflicted and that the negotiation process was "far from perfect." Nevertheless, the Court held that—assuming the entire fairness standard applied—the acquisition was entirely fair because Tesla ultimately paid a fair price and "a patently fair price ultimately carries the day."

At the time of Tesla's proposed stock-for-stock merger with SolarCity in 2016, Musk—Tesla's co-founder and CEO—owned 22% of Tesla's common stock. He was also chairman of the SolarCity board of directors and its largest stockholder, owning approximately 22% of SolarCity's stock. Musk was a vocal proponent of acquiring SolarCity—a solar company that was founded by Musk's cousins—because he wanted to integrate solar panels and batteries into Tesla's electric vehicles. At the time of the proposed merger, SolarCity was facing macroeconomic headwinds and liquidity problems that threatened its creditworthiness and its ability to remain compliant with its revolving debt facility's liquidity covenant. After due diligence and negotiations, Tesla ultimately offered to pay 0.110 shares of Tesla stock for each share of SolarCity stock—representing an equity value for SolarCity of approximately $2.1 billion or $20.35 per share of SolarCity common stock. Although not required under Delaware law, the acquisition was conditioned upon the approval of a majority of Tesla's disinterested stockholders. Tesla stockholders overwhelmingly voted to approve the acquisition, with approximately 85% voting in favor of the deal.

The plaintiffs alleged that the Tesla directors tasked with evaluating the acquisition had irreconcilable conflicts of interest based on their connections to the entity on the other side of the negotiating table. In fact, the *Tesla* plaintiffs alleged that all but one of Tesla's seven directors at the time of the acquisition were conflicted based on their connections to SolarCity. Tesla's controlling stockholder, Musk, was conflicted because he was chairman of the SolarCity board of directors and the largest stockholder of SolarCity. A second Tesla director previously served as SolarCity's CFO at Musk's request, did consulting work for SolarCity, owned SolarCity stock and did not even qualify as an independent director under the NASDAQ rules. A third Tesla director was Musk's brother, held stock in SolarCity and similarly did not qualify as independent under the NASDAQ rules. Two other Tesla directors personally owned significant stock in SolarCity, owned venture capital firms that invested significantly in SolarCity and had business partners that were on the SolarCity board. Despite these conflicts, Tesla did not form a special committee to evaluate the proposed merger. The Court noted that these "facts implicating the potential for self-interest or lack of independence" — "familial ties, personal friendships, 'thick' business relationships, cross-investments, etc." — were "all similar to scenarios where Delaware courts have found a reasonably conceivable disabling conflict" at the pleading stage.

The Court found that these conflicts and Musk's "apparent inability to acknowledge his clear conflict of interest and separate himself from Tesla's consideration of the Acquisition" led to procedural flaws in the due diligence and negotiating process. According to the Court, the process of negotiating the acquisition was "far from perfect" because "Elon was more involved in the process than a conflicted fiduciary should be" and "conflicts among other Tesla Board members were not completely neutralized." For example, Musk "actively participated" in certain Tesla board discussions regarding the acquisition and "had several private discussions directly with the target (SolarCity) and with Tesla's financial advisor for the deal without the knowledge of the Tesla Board."

However, the Court also acknowledged several "redeeming features" about the negotiating process that suggested fairness, including (1) the timing was right because solar companies were facing headwinds and trading at historic lows, (2) the acquisition was conditioned on the approval of a majority of disinterested stockholders, (3) Tesla selected an independent, top-tier financial advisor that performed "extensive diligence," conducted valuation analyses and ultimately concluded that the price was fair, (4) the financial advisor used the information discovered during its due diligence process to lower the price substantially, (5) in several instances, the Tesla board refused to follow Musk's wishes, (6) Tesla stockholders had ample information about the acquisition, which was well covered by analysts and (7) an indisputably independent director of the Tesla board led the due diligence and negotiations with SolarCity and "served as an effective buffer between Elon and the Tesla Board's deal process."

The Delaware Chancery Court in Tesla: *"The linchpin of this case … is that Elon proved that the price Tesla paid for SolarCity was fair – and a patently fair price ultimately carries the day."*

Ultimately, despite the conflicts of interest and ensuing procedural flaws, the Court held that "the Tesla Board meaningfully vetted the Acquisition" and that "the process did not 'infect' the price." The final price was critical to the Court's analysis. Indeed, the Court explained that "[t]he linchpin of th[e] case … is that Elon proved that the price Tesla paid for SolarCity was fair — and a patently fair price ultimately carries the day." The Court held that the price "put[] the nail" in plaintiffs' claims. In doing so, the Court equated the entire fairness standard to the idiom "all roads lead to Rome," explaining that "while there are necessary stops along the way, all roads in the realm of entire fairness ultimately lead to fair price."

The Court held that the price Tesla paid for SolarCity was fair based on (1) market evidence, (2) approval by a majority of disinterested stockholders, (3) the valuable cash flows that SolarCity has provided and will continue to provide to Tesla, (4) the independent financial advisor's fairness opinion and (5) the synergistic value created by the acquisition. With respect to market evidence, the Court relied on the fact that SolarCity's stock price at the time of the acquisition ($21.19 per share) was higher than the price Tesla ultimately paid ($20.35 per share) and was a reliable indicator of fair price because the market was sufficiently informed about

SolarCity's financial condition. In addition, the Court noted that nearly 85% of Tesla stockholders were in favor of the acquisition, which was "compelling evidence" of a fair price.

Acquiror May Be Liable After Agent Wires Merger Consideration to Hackers

Which party is responsible when hackers steal the merger consideration in an M&A transaction and disappear without a trace? The Delaware Chancery Court recently declined to dismiss a complaint charging the defendant acquiror and target companies with breach of contract and unjust enrichment after hackers intercepted emails between the plaintiff stockholders and the law firm for the merger and, posing as the stockholders, convinced the law firm and named defendants to wire the stockholders' share of the merger consideration to the hackers' Hong Kong bank account. *Sorenson Impact Foundation v. Continental Stock Transfer & Trust Co.* (Apr. 1, 2022). The Court found, at the plaintiff-friendly pleading stage, that the merger agreement may have given the acquiror a duty to pay the merger consideration to the correct recipients. The Court continued the question of whether the law firm, which acted as a go-between for the hackers, was a necessary party to the action.

Even though the merger agreement only explicitly required the acquiror to pay the merger consideration to the paying agent, the Delaware Chancery Court still found that the acquiror could be liable for failing to ensure that the stockholders entitled to the merger consideration ultimately received it.

In December 2019, Tassel Parent Inc. set out to acquire Graduation Alliance, Inc. Graduation Alliance's two stockholders sent a letter of transmittal to the paying agent, Continental Stock Transfer & Trust Co., directing it to pay the merger consideration to a bank account in Utah. Hackers gained access to emails between the stockholders and the law firm for the merger and began communicating with the law firm as the stockholders. They sent the law firm a new letter of transmittal that changed the location of the bank account to Hong Kong and the account name to "Hongkong Wemakos Furniture Trading Co. Limited." The hackers also failed to provide a "signature medallion guarantee," which the stockholders' original letter of transmittal explicitly required to ensure the authenticity of future changes to their payment information.

The law firm forwarded this new letter on to the paying agent. After noticing that the name on the bank account now differed from the stockholders' names on their stock certificates, the paying agent offered three methods of proceeding. They could (1) receive a signature medallion guarantee from a qualified guarantor, (2) receive approval from an authorized signatory to perform the name change without a signature medallion guarantee or (3) modify the names on the stock certificates to match the new name on the bank account. The acquiror and target chose the third option, resulting in the paying agent wiring the merger consideration directly to the hackers' designated bank account. Since the date of the Court's opinion, neither the merger consideration nor the hackers have been located.

The stockholders sued the paying agent, a New York company, for breach of contract. The Court dismissed the claim for lack of personal jurisdiction, finding that the paying agent had expressly provided in the paying agent agreement that it was "wholly unfamiliar with, and not bound by, the terms contained" in the merger agreement, including the merger agreement's Delaware forum selection clause. The paying agent was bound by the paying agent agreement, but it was governed by New York law. Further, the Court held that Delaware's long-arm statute did not apply because the paying agent had conducted business relating to the merger exclusively in New York.

The Court next dismissed the stockholders' breach of contract claim against the acquiror and target insofar as it related to the letters of transmittal because the letters lacked consideration. Similarly, the Court found that these parties could not be held vicariously liable for the paying agent's breaches of the paying agent agreement, which required the paying agent to "ensure the accuracy and completeness" of the stock certificate names, because vicarious liability only extends to torts. However, the Court rejected the acquiror and target's argument that they merely had a duty to *pay* the merger consideration (which the acquiror did in the accurate amount to the paying agent), finding it "reasonably conceivable that the Merger Agreement imposes an obligation on Parent to … ensure payment to the 'entitled' stockholders." The Court also denied the acquiror and target's

motion to dismiss as it related to the stockholders' unjust enrichment claim and continued their motion to dismiss for failure to join the law firm for the merger as a necessary party.

The Court's opinion provides valuable takeaways for M&A transaction parties:

- **Paying the merger consideration to *a* party may not be enough if hackers prevent the *correct* party from receiving it.** Even though the merger agreement only explicitly required the acquiror to pay the merger consideration to the paying agent, the Court still found that the acquiror could be liable for failing to ensure that the stockholders entitled to the merger consideration ultimately received it.
- **All parties to an M&A transaction, including law firms, should establish and follow robust authentication protocols.** The acquiror and target did not communicate directly with the hackers nor experience a data breach themselves, yet the Court still found that they could be liable. This suggests that every party to an M&A transaction should establish robust protocols regarding the payment of merger consideration, including how and when a party may alter its payment information, and take care to follow those protocols. It also suggests that stockholders should not agree to modifying the names on their stock certificates as a method of authenticating new payment information. The Court noted that the defendants were able to unilaterally select this method without even first consulting the hackers, let alone the actual stockholders.

A Recent Reminder for Outside Directors: Your Emails May Be Fair Game

As stockholders continue to seek expansive books and records collections, and particularly as requests for materials outside "formal" board materials become routine, it is worth reflecting on areas in which Delaware courts have continued to uphold boundaries with respect to Section 220 obligations. In a recent decision announced from the bench, Vice Chancellor Joseph R. Slights III offered a reminder of one such area: the non-company email accounts of outside directors.

While production of outside director documents stored outside of company servers may be required in special, outlier circumstances, companies should carefully consider a stockholder's Section 220 request for "all communications" where that broad category includes such documents and should evaluate carefully whether such documents are required to be produced.

Collection of materials outside the "formal" record in connection with a Section 220 request has been limited by Delaware courts except in limited circumstances (e.g., where a company conducts formal corporate business without documenting its actions in minutes and board resolutions or other formal means). In addition to these limitations, while stockholders often seek broad collection of "all communications" on a particular topic, Delaware courts have reminded stockholders that, when it comes to outside directors who are not employees of the company subject to the Section 220 demand, email records may not be part of the books and records of the company at all and so may fall outside of such a collection entirely.

Vice Chancellor Slights recently offered one such reminder in prohibiting access to the email records of outside directors located on the servers of the company that operated as the controlling stockholder of the company whose records were being sought. See *Firefighters' Pension System of the City of Kansas City, Missouri Trust v. Foundation Building Materials, Inc.* (Del. Ch. Jan. 7, 2022). He noted that the documents on the controlling stockholder company server "[were] not even books and records of the Defendant corporation or a subsidiary of the corporation, which are the only documents a stockholder has a right to compel inspection of under Section 220 absent a showing that directors were conducting board or company business on personal devices." The Court further articulated that because of that, and given the stockholders' duty to show how the books and records are necessary and essential to their stated purpose, "it is hard to see how these documents would be within the scope of a proper Section 220 production in any event."

In 2015, Vice Chancellor Donald F. Parsons Jr. articulated similar principles to those recently stated by Vice Chancellor Slights, that Section 220 only allows stockholders to inspect the corporation's "books and records" as well as its subsidiaries' books and records to the

extent the corporation has "actual custody and control of such records." *In re Lululemon Athletics Inc. 220 Litig.* (Del Ch. Apr. 30, 2015).

Other cases have come to a different conclusion, however, in particular where stockholders seek access to directors' personal devices as opposed to other companies' servers. For instance, Chancellor Andre G. Bouchard required the defendant corporation to turn over emails and messages stored on directors' personal accounts because they related to the directors' alleged breaches of fiduciary duty. *Schnatter v. Papa Johns Int'l, Inc.* (Del. Ch. Jan. 15, 2019). Though expressly declining to adopt a "bright-line rule," the Court instructed that, in regard to whether defendants must turn over communications from non-corporate devices, courts "should apply [their] discretion on a case-by-case basis to balance the need for the information sought against the burdens of production and the availability of the information from other sources." In part, the Court justified its position by way of policy, stating that "the utility of Section 220" would be undermined were the Court not to allow plaintiffs to collect directors' personal emails and communications. Other cases have likewise required defendants to turn over communications from personal or other non-corporate devices. See, e.g., *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752 (Del. Ch. 2016); *Ind. Electr. Workers Pension Trust Fund IBEW v. Wal-Mart Stores, Inc.* (Del. Ch. May 20, 2013).

While production of outside director documents stored outside of company servers may be required in special, outlier circumstances, companies should carefully consider a stockholder's request for "all communications" and should evaluate carefully whether such documents are required to be produced.

CORPORATE GOVERNANCE DEVELOPMENTS

CII Joins Global Investor Group to Launch Campaign Targeting Dual-Class Share Structures

A global group of institutional investors collectively managing $1 trillion in assets has formed the Investor Coalition for Equal Rights (ICEV) to advocate for equal voting rights at their portfolio companies. UK pension fund Railpen and the Council of Institutional Investors (CII) are co-leading the ICEV, which also includes the Minnesota State Board of Investment, the New York City Comptroller's Office, the New York State Common Retirement Fund, the Ohio Public Employees Retirement System and the Washington State Investment Board. The ICEV is concerned with the differential voting rights of a dual-class share structure because of the diluting effects on the ability of public shareholders to influence company management and weigh in on issues such as executive pay and corporate strategy. In the first phase of the campaign, the ICEV plans to engage with key market participants and policymakers to discuss the importance of proportionate voting power for long-term company performance. The ICEV will also focus on dialogue with pre-IPO companies and their investment bankers before they decide on the company's capital structure.

According to CII, approximately one-fourth (24%) of U.S. companies that went public in the first half of 2021 did so with a dual-class structure, just over half (51%) of which incorporated a "sunset" provision putting a time limit on the unequal voting structure.[13] CII has proposed draft legislation that would prohibit the listing of companies with multi-class stock with unequal voting rights unless they include a seven-year-or-less sunset period post-IPO or the unequal structure is approved by each class of shares voting separately. To support the seven-year timeframe, CII points to academic research conducted by the European Corporate Governance Institute that "found that while dual-class companies tend to have a value premium for a while after making their public debut, that benefit fades to a discount in six to nine years."

13 The Council for Institutional Investors' webpage devoted to the topic of dual-class stock is available at https://www.cii.org/dualclass_stock.

Shareholder support for proposals urging equal voting structures has increased in recent proxy seasons. According to Institutional Shareholder Services (ISS) data as of late June 2022, the seven shareholder proposals calling on U.S. companies to recapitalize for all stock to adopt a one-vote-per-share policy received average support of 29.9%. Although none of these proposals achieved majority support, they included votes at Alphabet (33.2%) and Meta (28.1%) that each would have seen support surpassing 95% had they been conducted on a one-vote-per-share basis.

Both ISS and Glass Lewis deem dual-class structures unfavorable to investors, which is reflected in their proxy voting policies. Beginning in 2023, ISS will recommend voting against the entire board at U.S. companies with a common stock structure with unequal voting rights, with an exception for newly public companies with a sunset provision of no more than seven years. As of 2022, Glass Lewis will recommend voting against the governance committee chair at companies with a multi-class share structure and unequal voting rights when the company does not provide for a reasonable sunset (generally seven years or less). Furthermore, Glass Lewis will recommend voting against all board members at a company where the board adopts a multi-class share structure in connection with an IPO or spin-off within the past year unless the board (1) agreed to submit the structure to a shareholder vote at the company's first shareholder meeting post-IPO or (2) provided for a reasonable sunset provision (generally seven years or less).

Companies considering going public should take this development into account when determining the appropriate capital structure.

Two California Laws Mandating Board Diversity Are Struck Down as Unconstitutional

This spring, judges in the Los Angeles County Superior Court ruled that two California laws mandating diversity on public company boards of directors were unconstitutional.

Corporations Code § 301.3 was passed into law as SB 826 in 2018 and required public companies with principal executive offices located in California (as disclosed on their Form 10-K) to have at least one female director by the end of 2019. By the end of 2021, a board composed of (1) six or more directors had to include at least three female directors and (2) five directors had to include at least two female directors.

Corporations Code § 301.4 was passed into law as AB 979 in 2020 and required California-based public companies to have at least one director from an "underrepresented community" by the end of 2021. The law stated that a director from an underrepresented community is an individual who identifies as "… Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual, or transgender." By the end of 2022, a board composed of (1) five to eight directors must include at least two qualifying directors and (2) nine or more directors must include at least three qualifying directors. Both laws required the California Secretary of State to publish compliance with these requirements and allowed it to impose fines of $100,000 for the first violation and $300,000 for subsequent violations.

For a more detailed discussion of the rulings finding the California board diversity mandates unconstitutional, see the Sidley blog post available here.

On April 1, 2022, Judge Terry A. Green of the Los Angeles County Superior Court struck down Corporations Code § 301.4. The Court held that the law posed a "total and fatal conflict" with the California Constitution's Equal Protection Clause by requiring corporations to use suspect demographic classifications in the selection of board members to the exclusion of other people from different races, sexual orientations or gender identities. The State unsuccessfully argued that there were compelling state interests to justify the statute because of a need to remedy discrimination in corporate director selection as well as various public benefits from diverse boardrooms (e.g., increased tax revenues from more profitable corporations and increased corporate integrity). The Court found that even if these interests were sufficient to

pass Constitutional muster, the law was not narrowly tailored to serve either concern as other neutral measures, such as voluntary surveys or seminars on the issue or requiring public disclosure of board composition, were not attempted.

The following month, on May 13, 2022, Judge Maureen Duffy-Lewis of the Los Angeles County Superior Court ruled that Corporations Code § 301.3 also violated the California Constitution's Equal Protection Clause. The State failed to show that there were sufficiently compelling state interests, such as better economic conditions and improving the workplace for women, to justify the use of a suspect, gender-based classification. Similar to the April ruling, the State's arguments were nevertheless irrelevant because the law was not narrowly tailored to accomplish boardroom gender diversity as no evidence was presented to show that the State Legislature considered other gender-neutral methods.

While California may no longer enforce California Corporations Codes §§ 301.3 and 301.4, the State has filed a notice of appeal with respect to the April ruling, and we expect that it will also appeal the May ruling. Public companies subject to the California board diversification laws must continue to follow the judicial trajectory of the rulings in deciding whether to comply with these significant legal requirements.

The recent rulings paint an early picture of the struggles state legislatures across the country may face if they enact laws mandating minimum levels of board diversity. State laws requiring public companies to disclose board demographics—rather than imposing specific mandates—would be less vulnerable to challenges and may become the preferred avenue for trying to improve corporate board diversity.

SEC DEVELOPMENTS

SEC Brings Enforcement Action Against Company for Using Employee Confidentiality Agreements That Impede Whistleblowing

The SEC continues to aggressively enforce its whistleblower protection rules and to be on the lookout for companies using agreements that may discourage employees from reporting possible securities law violations to the SEC.

On June 22, 2022, the SEC announced that it had taken enforcement action against The Brink's Company (Brinks) for using a confidentiality agreement prohibiting employees from disclosing confidential company information to third parties without Brinks' prior written approval that did not provide an exemption for potential SEC whistleblowers. The action demonstrates that the SEC continues to aggressively enforce its whistleblower protection rules and to be on the lookout for companies using agreements that may discourage employees from reporting possible securities law violations to the SEC.

In 2011, the SEC created the whistleblower program under the Dodd-Frank Wall Street Reform and Consumer Protection Act by adding Section 21F to the Exchange Act. Under the program, individuals who provide high-quality original information to the SEC that results in an enforcement action with monetary sanctions exceeding $1 million can receive an award ranging from 10% to 30% of such sanctions. Exchange Act Rule 21F-17 prohibits a company from "tak[ing] any action to impede an individual from communicating directly with the [SEC] about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement … with respect to such communications."

From 2015 to 2019, Brinks required thousands of its new U.S. employees to sign a confidentiality and non-competition agreement when they joined the company. The agreement prohibited employees from disclosing confidential information (which was broadly defined to include financial information) about the company to any third party without the prior written consent of a Brinks executive officer. A similar prohibition was included in other company agreements used in connection with employee departures and employee litigation.

The SEC brought nine enforcement actions between 2015 and 2017 alleging violations of Rule 21F-17. Soon after the first SEC enforcement action in 2015, Brinks' in-house lawyers

modified the confidentiality agreement template. But rather than resolving the problematic language impeding potential whistleblowers, they made the agreement more restrictive by adding a new provision subjecting any employee found to be in violation of the agreement to $75,000 in liquidated damages plus the company's legal fees.

In January 2017, Brinks modified its executive-level severance agreement template to add a whistleblower exemption provision but did not make corresponding amendments to the employee agreement templates used for rank-and-file employees. In May 2017, Brinks added whistleblower protection language to several employee litigation settlement agreements but not to any other employee agreements. Brinks ultimately modified its confidentiality agreement template to add a whistleblower exemption provision in April 2019, more than a year after the company knew it was the subject of the SEC staff investigation. In May 2019, Brinks added a notice on its corporate website stating that employees were permitted to provide confidential information to government agencies and receive whistleblower awards for doing so.

Brinks settled the recent enforcement action for a civil penalty of $400,000 and an agreement to add, within 10 days of the issuance of the SEC's order, the following provision to all employment-related agreements that prohibit U.S. employees from using or disclosing confidential company information:

> Protected Rights. Employee understands that nothing contained in this Agreement limits Employee's ability to file a charge or complaint with the Securities and Exchange Commission, or any other federal, state, or local governmental regulatory or law enforcement agency ("Government Agencies"). Employee further understands that nothing in this Agreement limits Employee's ability to communicate with any Government Agencies or otherwise participate in or fully cooperate with any investigation or proceeding that may be conducted by any Government Agency, including providing documents or other information, without notice to or approval from the Company. Employee can provide confidential information to Government Agencies without risk of being held liable by Brinks for liquidated damages or other financial penalties. This Agreement also does not limit Employee's right to receive an award for information provided to any Government Agencies.

Brinks also agreed, within 60 days of the issuance of the order, to make reasonable efforts to reach its current and former U.S. employees who signed the improperly restrictive confidentiality agreements between 2015 and 2019. Brinks undertook to provide them with a copy of the SEC's order and an explicit statement that the company allows them to (1) provide information and/or documents to, and/or communicate with, SEC staff without company approval or notice and (2) accept a whistleblower award from the SEC. Brinks committed to certify its compliance with these undertakings to the SEC in writing within 120 days of the issuance of the order.

In light of this enforcement action, companies should promptly review their agreements with, and policies applicable to, current and former employees and delete any language that (1) prohibits employees from communicating with government agencies without the company's prior consent or requires employees to notify the company regarding any such communications or (2) may otherwise deter whistleblowing or other communications or cooperation with government agencies.

If past agreements or policies contain improperly restrictive language, the company should consult with counsel regarding whether remedial action is advisable. With respect to future agreements or policies, companies may consider adding language clarifying that the agreement or policy does not (1) require employees to obtain approval from or notify the company prior to communicating with government agencies nor (2) limit an employee's right to receive a monetary award for providing information to the SEC or another government agency. In connection with that exercise, companies would be well advised to

review the Protected Rights provision language above that was endorsed by the SEC in connection with the Brinks settlement.[14]

SEC Publishes Sample Comment Letter on Disclosure Obligations Relating to Russia's Invasion of Ukraine and Related Supply Chain Issues

On May 3, 2022, the SEC published a sample comment letter containing useful guidance to public companies on their disclosure obligations related to the impact of Russia's invasion of Ukraine and related supply chain issues. The letter provides examples of the comments that the Division of Corporation Finance may issue to companies in response to insufficient disclosures.

The SEC recommends that companies disclose any direct or indirect material impact on their business resulting from the Russian invasion of Ukraine and provides several examples of factors that could cause such impacts.

- **Generally, disclose direct or indirect exposure to Russia, Belarus or Ukraine.** The SEC recommends that companies disclose any direct or indirect material impact on their business resulting from the Russian invasion of Ukraine. While these impacts are more obvious for companies that have operations in or conduct a material portion of their business in Ukraine, Russia or Belarus, other companies should also consider whether they have been impacted. Specifically, the SEC recommends disclosing any material impact resulting from:
  - sanctions against Russia or Belarus (or, in some cases, against entities or individuals)
  - legal or regulatory uncertainty associated with operating in or exiting Russia or Belarus, including limitations on a company's ability to obtain relevant or necessary government approvals, any impediment of the company's ability to sell assets or the nationalization of assets or operations
  - currency exchange limitations
  - export or capital controls
  - the reaction of investors, employees, customers and/or stakeholders to any company action or inaction arising from or relating to the invasion, including the payment of taxes to the Russian Federation
  - securities traded in Russia
  - direct or indirect reliance on goods or services sourced in Russia or Ukraine or, in some cases, in countries supportive of Russia
  - actual or potential disruptions to supply chains
  - business relationships, connections to, or assets in, Russia, Belarus or Ukraine
  - employees based in affected regions

If a company believes the impact is not material, it should explain why. Additionally, a company should describe the role of the board of directors in overseeing the risk related to any of the above-listed considerations.

- **Disclose heightened cybersecurity risk.** The SEC recommends that companies disclose, to the extent material, any new or heightened risk of potential cyberattacks by state actors or others since Russia's invasion of Ukraine and any actions taken to mitigate such risks.
- **Disclose any known trends or uncertainties impacting the company's financial condition.** The SEC recommends that companies disclose trends and uncertainties that are reasonably likely to have a material impact on cash flows, liquidity, capital resources, cash requirements, financial position or results of operations related to or arising from Russia's invasion of Ukraine.

14 Note that SEC Commissioner Hester Peirce issued a statement expressing her view that Brinks' undertaking to use the "particularly broad" language in future employee agreements "should not be misconstrued as an indication that other companies are under any obligation to use the same or similar language to avoid running afoul of Rule 21F-17."

- **Include additional information in critical accounting estimate disclosures.** The SEC recommends that companies enhance their critical accounting estimate disclosures related to impairment of assets, valuation of inventory, allowance for bad debt, deferred tax asset valuation allowance or revenue recognition, as applicable, so that such disclosures include both quantitative and qualitative information, to the extent material and reasonable available.
- **Disclose any material impact of import or export bans resulting from Russia's invasion of Ukraine.** The SEC recommends that companies disclose any material impact of import or export bans on any products or commodities used in their business or sold by as part of their business. Companies should take into account the availability of materials, cost of needed materials, costs and risks associated with transportation in their business and the impact on margins and customers.
- **Disclose the material impact of supply chain disruptions.** The SEC recommends that companies disclose the material impact of supply chain disruptions on business segments, products, lines of service, projects or operations. Companies should quantify the impact when it is possible to do so and describe any mitigation efforts.
- **Ensure that non-GAAP adjustments comply with Regulation G.** The SEC reminds companies that any non-GAAP adjustments related to lost revenue, revenue recognition and expenses in connection with Russia's invasion of Ukraine and/or supply chain disruptions must comply with Regulation G.
- **Disclose any changes to disclosure controls and procedures or internal control over financial reporting.** The SEC recommends that companies disclose any changes in the design of their disclosure controls and procedures or impact on management's conclusion of their effectiveness. Relatedly, a company should disclose any changes to its internal control over financial reporting resulting from Russia's invasion of Ukraine and/or related supply chain disruptions.

The SEC made clear that this is not an exhaustive list of considerations and that companies should evaluate their unique circumstances and disclose their potential risks appropriately.

SIDLEY RESOURCES

Corporate Governance; ESG

Governance Challenges 2022: Legal Considerations for Oversight of Climate-Related Risks (May 27, 2022). In the past few years, we have seen a remarkable acceleration in appreciation of the importance of ESG to corporate decision-making, enterprise risk management and a corporation's ability to withstand crisis. Companies face a growing set of expectations from employees, customers, investors and regulators with respect to how they incorporate ESG considerations into business decisions and how they mitigate and disclose risks related to ESG. The thesis is that companies that appropriately manage ESG risks and capitalize on opportunities are more resilient to adversity and perform better financially over the long term. Sidley partner Heather M. Palmer, co-leader of the firm's ESG and climate change practices, discusses these issues in an article published by the National Association of Corporate Directors.

M&A; SPACs

De-SPAC Mergers Facing Increased Scrutiny (June 14, 2022). Over the past year and a half we have seen an increased volume of complaints filed against special purpose acquisition company (SPAC) boards in the Delaware Chancery Court, challenging their decisions regarding de-SPAC mergers. In this article, Sidley partners Charlotte Newell, James Heyworth and Josh DuClos discuss the increased scrutiny.

Antitrust

Sidley Antitrust Bulletin: Our Take on Top-of-Mind Global Antitrust Issues (June 16, 2022). The Sidley Antitrust Bulletin provides thoughts on topics that are top-of-mind for Sidley's Antitrust team and why they matter to our clients. In May, the fifth Commissioner of the Federal Trade Commission (FTC) was sworn in, so the Democrats now have a majority of Commissioners and may try to meaningfully change FTC rules and guidelines. Despite anticipated agency efforts to expand the reach of the antitrust laws, the courts continue under the status quo, including through an Eleventh Circuit decision that shed some light on whether a private equity firm is capable of conspiring with its majority-owned portfolio company. Across the Atlantic, the European Commission is considering reducing the burden of information required in certain merger notification forms, and the revised block exemption for supply and distribution arrangements came into force in Europe.

Convergence in Antitrust and Privacy Law: An Interview With Colleen Brown and New Partner Sean Royall (May 17, 2022). Sean Royall, new Sidley partner and co-leader of the firm's global Antitrust and Consumer Protection practices, sits down with Colleen Brown to discuss the convergence in antitrust and consumer protection law. They cover the FTC's promotion of a more interdisciplinary approach of looking at data issues, the practical effects that closer coordination of the FTC's antitrust and consumer protection branches would have on clients and what law firms can be doing in response to the increasingly interrelated areas of antitrust and privacy.

SEC Rulemaking

SEC Again Reopens Comment Period on Proposed Compensation Clawback Rules and Posts Staff Memo With Supplemental Analyses and Data (June 14, 2022). On June 8, 2022, the SEC once again reopened the period to solicit input from the public on the compensation clawback rules it proposed in 2015 to implement Section 954 of the Dodd-Frank Act. The proposed rules would direct the national securities exchanges to establish listing standards that would require a company to adopt, disclose and comply with a compensation clawback policy as a condition of listing securities on a national securities exchange. The SEC reopened the comment period to give interested parties time to consider a memo prepared by its Division of Economic and Risk Analysis staff containing supplemental analyses and data about clawback policies and accounting restatements.

SEC to Require Electronic Filing of Forms 144 via EDGAR (June 14, 2022). The SEC has adopted amendments to its paper filing obligations, including requiring that Securities Act Forms 144 be filed electronically via its EDGAR database system. As a result, the historically hard-to-find Form 144 information concerning sales by affiliates will now be publicly available immediately after filing.

Corporate Compliance

U.S. DOJ's Compliance Certifications Put Chief Compliance Officers in Criminal Crosshairs (June 23, 2022). Chief compliance officers (CCOs) are facing the possibility of individual criminal liability under a new compliance certification requirement that the U.S. Department of Justice imposed as part of a recent Foreign Corrupt Practices Act settlement. CCOs and chief executive officers whose companies are subject to anti-corruption enforcement actions will likely be required to certify the effectiveness of their companies' compliance programs, subjecting both officers to individual criminal liability for any misrepresentations made via that certification.

SIDLEY EVENTS

Boston Life Sciences Roundtable

July 12 | Cambridge, MA

Sidley's 2022 Boston Life Sciences Roundtable will be held in Cambridge, MA on July 12. The annual program is designed to address cutting-edge trends and hot topics in the life sciences sector. The event is open to executives, investors, general counsel and company counsel. For more information, please contact globallifesci@sidley.com.

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