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SIDLEY

ANALYSIS

INTERLOCKING DIRECTORATES AND DEPUTIZATION

By Laura Collins and Karen Kazmerzak[1]

A corporate interlock violates Section 8 of the Clayton Act when a "person" serves as an officer or a director of two competing companies that exceed certain jurisdictional thresholds.

As discussed in our September 2022 issue of *Sidley Perspectives*, the U.S. Department of Justice Antitrust Division (DOJ) has prioritized interlocking directorates enforcement. A corporate interlock violates Section 8 of the Clayton Act, 15 U.S.C. § 19, when a "person" serves as an officer or a director of two competing companies that exceed certain jurisdictional thresholds.[2] If Section 8 does apply to the corporate interlock, there is a natural question: Who qualifies as a "person" under Section 8?

Roles

Section 8 of the Clayton Act prohibits a "person" from concurrently "serv[ing] as a director or officer in any two corporations … that are (A) engaged in … commerce; and (B) by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the antitrust laws…." 15 U.S.C. §19(a)(1).

A director is someone who serves on the board of directors and an officer is defined within the statute as "an officer elected or chosen by the Board of Directors." 15 U.S.C. § 19(a)(4). This means that a "person" could potentially violate Section 8 by (1) holding positions on the boards of two competing companies, (2) serving as board-appointed officers at two competing companies or (3) serving as a board-appointed officer at one company and on the board of its competitor.

Agency Theory

In certain cases, a non-officer employee or an agent of a company serving on the board of a competitor may give rise to Section 8 liability despite the wording of the statute. In *Square D Co. v. Schneider S.A.*, 760 F. Supp. 362 (S.D.N.Y. 1991), the district court judge held that Section 8 applies where a company tries to place its agents, who "have an employment or business relationship" with the company, on the board of a competitor. The court expressly rejected the literal reading of the statute finding that a literal reading would allow companies to "evade § 8 liability simply by calling its agents on the competitors' board something other than officers or directors."

This holding came with an exception: The decision noted that Section 8 would not apply when the agent appointed to the board was appointed only "to consummate a takeover," if that agent did "not otherwise have a business relationship — such as that of officer, director or employee — with the firm promoting his election." That is, the court was willing to consider expanding the reading of Section 8 to encompass agents without an officer or director title if those agents would have the same potential effect on competition as a long-standing board member or officer, but it was not willing to read the statute to reach agents that would be unlikely to have an effect on competition.

Deputization Theory

It is clear from the text of the statute that Section 8 of the Clayton Act applies to individuals, but a few opinions and agency practice embrace the view that the definition of "person" in Section 8 of the Clayton Act extends beyond natural persons, adopting the "deputization" theory established by the courts in litigation related to Section 16(b) of the Securities

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2 For Section 8 to apply in 2022, each of the companies must have assets exceeding liabilities of $41,034,000 or more. Even if the two companies exceed this threshold, Section 8 would not apply if (1) the competitive sales of either company are less than $4,103,400 (2022 threshold) or less than 2% of its total sales or (2) if the competitive sales of each company are less than 4% of its total sales.

Exchange Act of 1934 (the Exchange Act). The government first articulated this theory to the courts in *United States vs. Cleveland Trust Co.*,[3] where the United States argued "that under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(p)(b) a corporation may be deemed to sit on the Board of Directors of another corporation through a 'deputy'...." Ultimately, the court declined to find for the government in summary judgment on the Section 8 issues because the deputization question was "entirely unsettled and unquestionably is in genuine controversy," and the parties settled before the issue was litigated in court.[4]

Nearly three decades later, another district court explicitly relied on a deputization theory and found that Section 8 of the Clayton Act prohibited the conduct alleged in a private case. The court in *Reading International v. Oaktree Capital Mgmt. LLC,* 317 F. Supp. 2d 301 (S.D.N.Y. 2003) explained, "in any meaningful sense, someone who controls a board seat through such an agent or deputy 'serves' on the board. Section 8 would be a formalism if it merely prevented the same person from being officially named as a director of competing corporations. Of course, and critically for the instant case, a corporation can 'serve as a director' in this *de facto* sense...." The court again imposed some practical limits on this deputization theory: For a corporation to "serve as a director" through an individual, the individual must be serving on the board "acting as the puppets or instrumentalities of the corporation's will, such that it legitimately can be said that it is [the corporation as an entity] ... which 'serves as a director'...."

Practice Points

To avoid costly and burdensome investigations or unfavorable publicity, companies with agents or deputies serving as officers or directors of multiple companies should review Section 8 compliance.

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Under the current threshold, all companies with assets exceeding liabilities of $41,034,000 are potentially subject to Section 8 of the Clayton Act. As those companies consider antitrust risks as well as opportunities to use antitrust as a tool, it is worth keeping the following points in mind:

- The DOJ has ongoing investigations into Section 8 violations, and it has support from *Reading International* to pursue Section 8 cases under a deputization theory of harm.
- To avoid costly and burdensome investigations or unfavorable publicity, companies with agents or deputies serving as officers or directors of multiple companies should review Section 8 compliance. Because businesses change — as do the thresholds — it is worth revisiting corporate interlocks annually.
- Companies facing activist investor board nominations may find that Section 8 would prohibit one or more nominees from service under the deputization theory.

BOARD OVERSIGHT OF COMPLIANCE RISK

By Holly J. Gregory and Justin C. Nowell[5]

Recent guidance from the DOJ signals a more aggressive approach to corporate crime through heightened expectations about the pace of corporate internal investigations and related disclosures to the DOJ. The guidance underscores that to avoid prosecution or at least minimize penalties in the event of a significant compliance failure, corporations must self-report compliance problems early and provide information about the senior executives

3 392 F. Supp. 699, 710 (N.D. Ohio 1974), aff'd mem. 513 F.2d 633 (6th Cir. 1975).

4 *United States v. Cleveland Trust Co.*, 1975 U.S. Dist. LEXIS 15282 (Nov. 14, 1975).

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involved. Boards of directors that decide to pare back on compliance efforts on the theory that "what isn't detected can't be reported" would be seriously misguided. Rather, boards should review whether the corporation's ethics and compliance systems (including related policies and training programs) are well-designed to position the corporation to detect problems. They should also consider self-reporting early if they want to get full cooperation credit from the DOJ.

New DOJ Guidance Prioritizes Investigation of Individuals and Timely Disclosures

On September 15, 2022, Deputy Attorney General Lisa Monaco issued a memo providing guidance on the DOJ's corporate enforcement policy (the Monaco memo), building on prior DOJ guidance. The Monaco memo reaffirms that when a corporation voluntarily self-discloses, fully cooperates and promptly remediates, absent aggravating factors, the DOJ will not seek a guilty plea from the corporation. It also emphasizes the DOJ's interest in pursuing individuals who engage in misconduct: "The Department's first priority in corporate criminal matters is to hold accountable the individuals who commit and profit from corporate crime."

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This emphasis on individual misconduct shapes the DOJ's definition of corporate cooperation. Specifically, to receive full cooperation credit, a corporation must timely produce "all relevant, non-privileged facts and evidence about individual misconduct such that prosecutors have the opportunity to effectively investigate and seek criminal charges against culpable individuals." This includes prioritizing the production of evidence to the DOJ that is most relevant for assessing individual culpability, including "information and communications associated with relevant individuals during the period of misconduct."

The guidance directs prosecutors to try to complete investigations into individuals (and seek appropriate criminal charges if any) prior to, or simultaneously with, resolution of the matter with the corporation. Prosecutors must also specifically assess whether the corporation cooperated in a timely manner prior to resolution. In assessing timeliness, prosecutors are to consider whether the corporation unduly or intentionally delayed its production of relevant information. Even where the corporation shares significant facts, delay in disclosure to the DOJ places eligibility for cooperation credit in jeopardy. (Note that the DOJ intends to update the Justice Manual to provide consistent guidelines for cooperation credit.)

In prior guidance, the DOJ has instructed prosecutors to consider a corporation's history of misconduct as well as the efficacy of a corporation's compliance program. The Monaco memo clarifies that with respect to prior history, the greatest weight should be placed on prior U.S. criminal prosecutions and prior misconduct involving the same personnel. With respect to the efficacy of a company's compliance program, the new guidance clarifies that it should be assessed both at the time of the offense and at the time of charging. This later assessment gives the corporation an opportunity to receive some credit for making improvements to the program. Prosecutors are to consider whether the corporation's compliance program is "well designed, adequately resourced, empowered to function effectively and working in practice." In assessing a compliance program's mechanisms for identifying and investigating problems, prosecutors should consider the efficacy of the corporation's policies governing the use of personal devices and third-party messaging platforms. In addition, the guidance suggests that prosecutors will determine the role of compensation structures in rewarding compliance and penalizing noncompliance.

Board Responsibilities for Oversight of Compliance

Effective compliance systems are central to establishing an ethical culture in a company while also helping to deter compliance failures and detect problems early. They help prevent and mitigate risk and the significant costs associated with compliance failures. As evidenced by the Monaco memo and earlier DOJ guidance (including in the form of prosecutorial and sentencing guidelines), an effective compliance program can influence a

federal prosecutor's decision whether to charge a corporation for the bad acts of its employees or officers and the extent to which the corporation may receive credit for cooperation in a settlement or influence a court in its determination of penalties.

Directors have a key role in providing oversight of corporate compliance efforts. As fiduciaries, directors must exercise reasonable care and good faith to ensure that the corporation is being managed in compliance with law, regulation and corporate policies. Over the past several decades, a series of Delaware cases, beginning with *In re Caremark International Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996), have emphasized that as fiduciaries, directors must consider the legal and regulatory compliance framework that has developed and ensure that the corporation has appropriate compliance-related reporting and information systems and internal controls in place. *Caremark* and subsequent Delaware cases remind boards to pay attention to prosecutorial and sentencing guidelines and the opportunities they provide to defer prosecution and mitigate corporate and individual penalties.

Compliance programs, information and reporting systems, and related controls all need to be designed in light of this framework to deter and detect compliance violations and provide senior management and the board with "timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance" (*Caremark*, 698 A.2d at 970).

Key Takeaways and Practical Guidance

The board (or delegated committee) should ensure that the corporation's information and reporting systems contemplate the key compliance risks it faces, and these systems should be reasonably designed to provide the board with timely, accurate information sufficient to allow it to reach informed judgments concerning the corporation's compliance with laws and oversight of risk.

Boards should review the company's compliance systems and assess whether they are fit for the purpose of preventing and mitigating compliance failures. Boards should also consider whether the company is well positioned to identify and investigate potential violations with agility so as to be positioned to self-report to the DOJ if appropriate. Boards should consider the following:

- **Key compliance risks.** Do we understand the key compliance risks facing the corporation and how those specific key compliance risks are monitored and mitigated? Have we established clear expectations about the circumstances and timeframe for the board or a board committee to be informed and involved in compliance matters that arise?
- **Compliance culture, programs and systems.** Do we understand and oversee the compliance culture, programs and systems that management has put in place to identify, manage and mitigate risks as well as to respond to risk incidents that arise? The duty of oversight is discharged in large measure by ensuring that the corporation has implemented appropriate compliance programs and systems designed in relation to the risk profile of the corporation, including any critical compliance risks.
- **Information and reporting systems.** Do we periodically review and assess whether the company has appropriate information and reporting systems in place to keep management and the board informed of compliance issues? This is especially important in light of the Monaco memo's emphasis on the importance of timeliness in voluntary self-disclosures. The board (or delegated committee) should ensure that the corporation's information and reporting systems contemplate the key compliance risks it faces, and these systems should be reasonably designed to provide the board with timely, accurate information sufficient to allow it to reach informed judgments concerning the corporation's compliance with laws and oversight of risk.

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The board (and any delegated committee) should set clear expectations with management about the circumstances in which compliance issues should result in a board or committee report. In addition, the board (or delegated committee as appropriate) should hear, on a regular basis, from the senior executives with overall responsibility for the most significant risk areas and, if there is an issue in a significant risk area, should ensure that management has an appropriate plan for addressing the risk and regularly updates the board or committee regarding that plan.

- **Incentives.** Do we understand how compensation relates to compliance, including whether compliance is rewarded and/or compliance failures are penalized? Incentives could include use of compliance metrics in compensation and promotion decisions, and penalties could include "clawback" measures.
- **Accountability.** Have we considered how accountability is built into the compliance program to ensure that the corporation takes action and holds itself accountable when wrongdoing occurs? The compliance program may do this by communicating that individuals at any level of the corporation who violate corporation standards or the law will be disciplined, maintaining an excellent investigative system and enforcing rules by taking disciplinary action when violations are substantiated. Boards may also improve accountability by following the Monaco memo's guidance on compensation structures (such as "clawbacks" as a penalty for compliance violations).

  The board should assess whether there are effective systems for escalation and response and regularly test them, ensuring that leaders are held accountable for compliance failures and that the company is positioned for voluntary self disclosures to regulatory or other government authorities. Mechanisms for accountability at all levels of the corporation should align with the Monaco memo's priority of holding accountable the individuals who commit and profit from corporate crime.
- **Annual assessment of compliance programs and systems.** On an annual basis (and more frequently if issues arise), does the board or delegated committee assess compliance programs and systems to ensure both that they are performing in alignment with the standards set forth in DOJ guidance, federal sentencing guidelines for organizations and other influential resources on board oversight of compliance risk and compliance program effectiveness?

  This review should consider alignment of compliance programs and systems with the key compliance risks facing the corporation, which evolve over time as the corporation's business and compliance environment change (e.g., the growing need to address risks related to the use of personal devices and third-party messaging applications); the effectiveness of reporting hotlines and whistleblower mechanisms; and whether changes are appropriate, based on compliance issues that arise. This is especially important for corporations with a history of misconduct, given that the Monaco memo instructs prosecutors to consider the extent to which remediation has occurred. Ongoing development of compliance programs may also prevent the DOJ from imposing an independent monitor in the organization in the wake of a compliance failure.

Effective compliance systems are central to establishing an ethical culture in any corporation and help prevent compliance failures and detect problems earlier, thereby mitigating risk, including the potentially significant costs – both monetary and reputational – associated with compliance failures.

The Monaco memo's guidance reinforces the importance of board attention to compliance systems. Effective compliance systems are central to establishing an ethical culture in any corporation and help prevent compliance failures and detect problems earlier, thereby mitigating risk, including the potentially significant costs — both monetary and reputational — associated with compliance failures. It is evident that the DOJ remains committed to rewarding companies — through deferred prosecution and lighter penalties — for cooperation and genuine commitment to compliance.

WHAT DO THE FIRST-EVER CFIUS ENFORCEMENT AND PENALTY GUIDELINES MEAN FOR YOUR BUSINESS?

By Jen Fernandez and James Mendenhall[6]

On October 20, 2022, the U.S. Department of the Treasury (Treasury) released the first-ever Committee on Foreign Investment in the United States (CFIUS or the Committee) Enforcement and Penalty Guidelines (Guidelines), which describe how the Committee assesses violations of CFIUS regulations and imposes penalties.

How will the Committee assess violations of applicable CFIUS regulations and impose penalties? And what does this mean for your business?

The Guidelines signal a strong commitment to the enforcement of the CFIUS regulations. Indeed, CFIUS has in recent years demonstrated an increased willingness to impose penalties. For example, CFIUS imposed a $1 million civil penalty in 2018. CFIUS also imposed a $750,000 civil penalty in 2019.

The focus on enforcement, coupled with the renewed CFIUS focus on identifying non-notified transactions and monitoring compliance, means that now more than ever, parties face serious penalties if they do not take their regulatory obligations seriously.

The focus on enforcement, coupled with the renewed CFIUS focus on identifying non-notified transactions and monitoring compliance, means that now more than ever, parties face serious penalties if they do not take their regulatory obligations seriously. As with all matters related to CFIUS, cooperation, transparency and building trust are critical to any successful outcome or mitigation of any penalties. What this means:

- Parties should conduct proper and thorough diligence when they enter into a transaction to ensure they are complying with any CFIUS filing requirements.
- Parties should ensure that any CFIUS filings are complete and accurate and do not misstate or omit material information.
- Parties should put in place policies, procedures and personnel training to ensure compliance with any applicable CFIUS mitigation agreement.
- Parties should cooperate fully with any inquiry from CFIUS.
- If parties identify any violation of the CFIUS regulations or a mitigation agreement, it is advisable to disclose the problem to CFIUS as soon as possible and take corrective action.

When engaging with CFIUS after a potential violation, it is important to explain fully the circumstances that led to the problem identified, and the party should include any exculpatory evidence, evidence that the party sought to report/mitigate the problem in a timely fashion, and evidence that the party adopted procedures and policies to prevent future violations. Below, we highlight the main points from the Guidelines.

What constitutes a violation, and what are the potential penalties?

The CFIUS regulations and Guidelines identify three types of violations and corresponding penalties:

- **Material misstatement/omission or false certification in connection with a declaration or notice:** a civil penalty of up to $250,000 per violation.
- **Failure to make a mandatory filing:** a civil penalty not to exceed $250,000 or the value of the transaction, whichever is greater.
- **Noncompliance with CFIUS mitigation:** subject to certain qualifications, a civil penalty not to exceed $250,000 per violation or the value of the transaction, whichever is greater.

In addition, mitigation agreements may include liquidated damages clauses. These penalty provisions are without prejudice to other penalties, civil or criminal, available under law. The Guidelines do not change these rules but provide significant insights on how Treasury will determine appropriate penalties.

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It is important to understand that a violation does not automatically lead to a penalty or other remedy. Rather, CFIUS will take into account the specific nature of the violation and the way in which parties respond to the violation. For example, if a party violates a mitigation agreement at the start of the agreement, and the party immediately self-reports the violation, has a history of compliance, and is fully transparent with the Committee, CFIUS may decide not to penalize the party. Conversely, if a party has violated a mitigation agreement multiple times, attempts to conceal the violation or delay reporting it, and is not cooperative with the Committee, CFIUS would likely penalize the party.

How does CFIUS discover a violation?

CFIUS relies on information from a variety of sources. For example, a third-party auditor/monitors might discover a violation of a mitigation agreement, or CFIUS might discover information about noncompliance with a mitigation agreement during a site visit. CFIUS might discover non-notified transactions through public information, including information submitted to other U.S. government agencies (e.g., Securities and Exchange Commission (SEC) filings), publications, press releases and other media sources, or litigation filings. CFIUS might also obtain classified information or may obtain information through tips via email or phone.

The Guidelines encourage self-disclosure and indicate that self-disclosure may be a mitigating factor when assessing penalties. CFIUS will consider the timeliness of any disclosure, whether disclosure occurred prior to discovery by the U.S. government, and compliance with any disclosure requirements in a mitigation agreement.

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During Treasury's Inaugural CFIUS Conference in June 2022, CFIUS staff noted that the Committee will increasingly seek proof of compliance (self-reporting of compliance will not be sufficient), there will be increased numbers of audits and site visits, and a "trust but verify" policy will be applied, including to third-party monitors.

How does the penalty process work?

The penalty process is as follows:

1. CFIUS will send a notice of penalty, including a written explanation of the conduct to be penalized and the amount of any monetary penalty to be imposed.
2. Within 15 business days of receipt of a notice of penalty, a party may submit a petition to CFIUS for reconsideration.
3. If the party does not submit a petition for reconsideration, CFIUS may issue a final penalty determination.
4. If a party files a timely petition for reconsideration, CFIUS will issue a final penalty determination within 15 business days after receiving the petition.

How does CFIUS determine penalties?

CFIUS will determine the appropriate penalties to impose based on the specific facts of the violation and other potential aggravating or mitigating factors. The Guidelines provide the following non-exhaustive list of potential aggravating or mitigating factors:

- Whether enforcement will protect national security or promote self-disclosure and compliance
- The harm caused by the violation to U.S. national security
- Whether the violation was due to simple negligence, gross negligence or intentional action or was willful
- Any efforts to conceal or delay the sharing of relevant information
- The seniority of personnel involved in the violation
- The length of time between discovery of the violation and the disclosure to CFIUS

- The frequency and duration of the violative conduct
- The date of the transaction at issue if parties failed to file
- Whether the party self-disclosed the violation and when it was disclosed
- How the parties attempted to remediate the violative conduct
- Any internal review conducted to understand the violation
- The violating party's history and familiarity with CFIUS
- Any compliance programs, policies, trainings and/or procedures related to compliance with CFIUS and mitigating measures

Treasury's press release is linked here, the Guidelines are linked here, and examples of enforcement actions to date, which will be updated as appropriate, can be found here (for failure to comply with interim order) and here (for breaches of mitigation agreements).

VOLUNTARY DISCLOSURES PROVE A USEFUL TOOL IN TAX LIABILITY TALKS

By Katharine A. Funkhouser, Tara M. Lancaster and Richard M. Silverman[7]

In an M&A transaction, the buyer and seller must determine how best to address any unknown or unresolved state tax exposure due to failure to file returns and pay taxes in jurisdictions in which the business has a nexus. This issue has become more pervasive in the wake of the U.S. Supreme Court's decision in *South Dakota v. Wayfair*[8] permitting states to impose sales tax on businesses with no physical presence in the jurisdiction.

Remediating state tax exposure through a voluntary disclosure agreement (VDA) can be a desirable path because a VDA typically limits the look-back period to three to five years and reduces or eliminates penalties for the look-back period. This article discusses how parties approach VDAs in connection with mergers and acquisitions.

A voluntary disclosure agreement can be beneficial to both sides in an M&A transaction. By stressing the extent to which the parties are aligned, a buyer and a seller may be able to negotiate more efficiently to mitigate overall tax liabilities.

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Overview of VDA Process

The VDA process is fairly straightforward. Third-party advisers can engage with a tax authority anonymously during most or all of the negotiation phase, or a client may engage with state tax authorities directly. The client then enters into a non-negotiable agreement provided by the tax authority and files the appropriate tax returns for the relevant period(s).

Seller and Buyer Alignment

A seller with pre-closing tax indemnity obligations often will hesitate to seek a VDA. A seller may be concerned that a buyer will be too willing to concede tax liability issues due to the buyer's economic indifference to resolving a VDA. In practice, however, a buyer's acceptance of extensive nexuses would lead to higher post-closing operating costs in the form of increased tax liabilities. Additionally, if a seller is or becomes uncreditworthy, the buyer will have no avenue for recovery and will have to make VDA payments itself.

A seller may view the VDA process as increasing its tax indemnity obligation. This view is often mistaken. If a buyer intends to begin filing tax returns in a state, a seller's failure to previously file required tax returns there will become apparent. A VDA is a cost-effective solution to limiting the seller's exposure to compounding unpaid taxes, penalties and

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8 *South Dakota v. Wayfair, Inc.*, 180 S. Ct. 2080 (2018) as discussed in the Sidley Update available here.

A voluntary disclosure agreement is a cost-effective solution to limiting the seller's exposure to compounding unpaid taxes, penalties and interest.

interest. Ultimately, a buyer and a seller should be aligned regarding a VDA process, even where a seller has given a pre-closing tax indemnity.

VDA Mechanics in a Purchase Agreement

In the absence of a specific provision governing VDAs, the VDA process typically is governed by the amendment of tax returns provision in a purchase agreement. A buyer concerned about unresolved state tax liability should negotiate the amendments provision with care in the absence of a VDA provision.

VDA provisions in a purchase agreement should cover (1) who controls the process, (2) what role, if any, the counterparty has and (3) the interplay between VDA-related payments and the indemnity provisions.

Common Areas of Negotiation

- **Initiation.** A buyer will ask for the ability to initiate VDA proceedings in its sole discretion, while a seller will want to negotiate for consent rights over initiating a VDA proceeding. Although this provision in a purchase agreement is highly negotiated, both sides ultimately are aligned and should be amenable to VDAs for the reasons discussed above.
- **Control.** Negotiations over control of the VDA process are typically the most contentious. The VDA process is inherently backward-looking. As such, a seller will view the proceedings as predominately a seller issue — especially because the seller will bear the tax burden and potentially third-party advisory costs of the process. A buyer, on the other hand, will want to fully control the processes because it typically owns the company at the time the VDA is consummated. At a minimum, a seller typically will ask to review and comment on all VDA filings. A creditworthy seller may be able to require the buyer to incorporate the seller's reasonable comments into the VDA filings or obtain a consent right.
- **Duration and timing.** A seller often wants finality and certainty with respect to its historic tax obligations. Accordingly, a seller will negotiate to limit the duration of the VDA process. Third-party advisers familiar with the VDA process in a specific jurisdiction can advise on what is a realistic timeframe. Because a VDA typically does not reduce interest owed, all parties should want to begin the process as soon as possible. Sometimes the process begins prior to closing a deal. This is often an efficient path forward but makes the determination as to who should control the process more nuanced.
- **Indemnification provisions.** Often a seller will seek to cap its liability by setting a total dollar limit or indemnifying only certain jurisdictions. When negotiating a cap (and generally the scope of the indemnification), a buyer should attempt to ensure that the cap covers third-party expenses incurred in connection with obtaining the VDA. These costs can be as large as the amount due to the state taxing authority as part of the agreement.

  In addition, the creditworthiness of the seller should not be overlooked. For example, the seller may be comprised of individuals or a private equity fund toward the end of its lifecycle. An escrow is often appropriate for VDA-related liability: the liability will be known within a relatively short amount of time (compared with federal income tax audit risk, for example), and the amount of liability and third-party costs can be estimated. Because this indemnity could be outstanding longer than a general purchase agreement indemnity, and because the amount is more predictable in nature than a general indemnity, the parties should consider a separate VDA-related escrow.

Role of Due Diligence

Tax due diligence informs the VDA process. Diligence will allow the parties to estimate potential unpaid state tax liability, which may be used to determine what cap, if any, is appropriate, whether the cap should be imposed on a state-by-state basis, and the amount of any escrow. A buyer also should confirm whether states identified in diligence reflect all

state tax exposures or whether there are other state tax exposures (whether or not material) that have not been listed. If a voluntary disclosure significantly understates tax liability, it may render the agreement non-binding and allow the state to look back to all prior periods.

Although heavily negotiated in purchase agreements, a VDA is beneficial to both buyers and sellers. By stressing the extent to which parties are aligned, a buyer and a seller may be able to negotiate more efficiently to mitigate overall tax liabilities.

NEWS[9]

JUDICIAL DEVELOPMENTS

Delaware Chancery Court Finds Scope of Restrictive Covenants Unreasonable in the Context of a Business Sale

In Kodiak, *the Delaware Chancery Court found that restrictive covenants were unreasonable in their geographic scope and scope of restricted activities because they were broader than necessary to protect the acquirer's legitimate economic interests.*

A recent Delaware Chancery Court decision addressed whether a restrictive covenant agreement was enforceable against a defendant who entered into that agreement willingly (and who waived his right to contest its reasonableness) as part of a sale of a business. *Kodiak Building Partners, LLC v. Adams (Del. Ch. Oct. 6, 2022)*. The court held that the restrictive covenants were unreasonable in their geographic scope and scope of restricted activities because they were broader than necessary to protect the acquirer's legitimate economic interests. This decision provides lessons for lawyers seeking to draft clear, effective and enforceable restrictive covenant provisions.

Plaintiff Kodiak Building Partners (Kodiak) is a Delaware LLC that acquires and operates smaller companies in the construction industry nationwide. Kodiak acquired defendant's former employer, Northwest Building Components, Inc. (Northwest), through a stock purchase agreement entered into in June 2020. As part of the transaction, Kodiak acquired defendant's 8% interest in Northwest and entered into a restrictive covenant agreement with defendant. This agreement prohibited defendant, among other things, from soliciting Kodiak's customers and clients and competing with Kodiak's business within the states of Idaho and Washington or 100 miles from any of Kodiak's businesses during a 30-month term. A few months after the acquisition, defendant resigned from Northwest and took a position with a roof truss and lumber business located 24 miles away from Northwest. In response, Kodiak sued defendant for breach of the restrictive covenant agreement and sought a preliminary injunction.

While the court acknowledged that noncompete and nonsolicit covenants included as part of a business sale are generally examined with less scrutiny than similar covenants in employment agreements, it still asserted its right to apply the common law reasonableness test to the covenants to further the "public interest of competition." The court further noted that it had the power to review this restrictive covenant despite the fact that defendant initially agreed that the covenant was reasonable, and also initially agreed to waive challenges to its reasonableness.

Despite the voluntary nature of the agreement, the court stated that "[p]ublic policy requires Delaware courts to evaluate noncompetition and nonsolicitation contracts holistically, carefully, and nonmechanically, with an eye towards reasonableness, equity, and the advancement of legitimate business interests." The court thus held that the parties could not avoid a public policy examination of the agreement's reasonableness. This was a crucial decision in light of the fact that, when it comes to overbroad restrictive covenants, Delaware courts are more likely to find them entirely invalid rather than "blue pencil" the agreements to make them enforceable.

9 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Jaime Bartlett, Tyler Baylis, Beth Berg, Scott Gregus, Claire Holland, Katie LaVoy, Kai Liekefett, Laura McKenzie, Ashley Wong, Leonard Wood and Derek Zaba. 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.

Delaware Chancery Court in Kodiak*: "Restrictive covenants in connection with the sale of a business legitimately protect only the purchased asset's goodwill and competitive space that its employees developed or maintained. The acquirer's valid concerns about monetizing its purchase do not support restricting the target's employees from competing in other industries in which the acquirer also happened to invest."*

In relevant part, the agreement sought to impose noncompete and nonsolicit provisions against defendant relating to activity similar to, or in competition with, any of Kodiak's "Business." "Business" was defined broadly as "manufacturing, marketing, selling, distributing, installing and/or delivering of trusses; roof, floor and stair components; framing; siding and other building materials and supplies, and providing services with respect thereto, including design, engineering, turn-key solutions, project management and trade coordination services," which includes more services than Northwest offers. Defendant was involved only in truss and lumber operations.

While Kodiak had a "legitimate economic interest" in protecting its purchased assets, the court found that its noncompete and nonsolicit covenants were impermissibly overbroad. Importantly, the court held that "[r]estrictive covenants in connection with the sale of a business legitimately protect only the purchased asset's goodwill and competitive space that its employees developed or maintained," but does not allow restricting an employee "from competing in other industries in which the acquirer also happened to invest." Therefore, the court held that the restrictive covenants could not serve to limit defendant's participation in business lines "unrelated to truss and lumber operations," and therefore were unenforceable.

The court also held that the geographic scope of the restrictive covenants was overbroad in that it purported to prohibit competition and solicitation in areas around Kodiak's subsidiaries other than Northwest and, as such, Kodiak failed to show that the geographic scope was necessary to protect its legitimate economic interests in Northwest.

In light of *Kodiak*, transactional lawyers should proceed with caution when drafting restrictive covenant agreements in the context of a business sale. These agreements risk being invalidated entirely by Delaware courts rather than blue-penciled, even if entered into voluntarily and with a reasonableness waiver. As a result, lawyers should carefully consider the purpose, scope and necessity of such agreements and narrowly tailor them to the acquirer's interest in the purchased assets.

The Forum Selection Saga Continues

On October 24, 2022, the Ninth Circuit granted *en banc* review in *Lee v. Fisher*, 34 F.4th 777 (9th Cir. 2022), vacating the Circuit's prior ruling that the forum selection clause in the bylaws of Gap Inc. is enforceable. This is the latest chapter in the saga of forum selection enforceability that has gripped the courts and litigants for years. With this ruling, the Ninth Circuit is set to consider whether forum selection clauses are enforceable even if they result in a waiver of substantive rights under federal law. A ruling enforcing Gap's clause will leave the Ninth and Seventh Circuits in direct conflict, while a ruling against Gap could bring the two circuits back into alignment.

Plaintiff Noelle Lee originally brought her derivative lawsuit in the federal district court in California, alleging that Gap failed to honor its commitment to diversity in violation of Section 14(a) of the Exchange Act. Plaintiff's Section 14(a) claim is subject to exclusive federal jurisdiction, but the district court dismissed the case for *forum non conveniens*, concluding that the case should have been filed in the Delaware Chancery Court in accordance with the forum selection clause in Gap's bylaws. Plaintiff appealed, arguing that Gap's forum-selection clause violates public policy and is unenforceable because it prevents her from bringing a derivative Section 14(a) claim in any court.

As noted, the forum selection dispute in *Lee v. Fisher* follows several years of litigation regarding jurisdiction under the Securities Act of 1933, which permits plaintiffs to choose whether they would bring their action in state or federal court and the enforcement of forum selection clauses in cases under that Act. In *Cyan Inc. v. Beaver County Employees Retirement Fund*, the U.S. Supreme Court preserved the bar on removing securities class actions brought in state court under the Securities Act of 1933 to federal court, thus limiting corporations' ability to direct litigation to federal forums. In *Salzberg v. Sciabacucchi*, the

The Ninth Circuit is set to consider whether forum selection clauses are enforceable even if they result in a waiver of substantive rights under federal law. A ruling enforcing Gap Inc.'s forum selection clause will leave the Ninth and Seventh Circuits in direct conflict, while a ruling against Gap could bring the two circuits back into alignment.

Delaware Supreme Court upheld the validity of a Delaware corporation's certificate of incorporation requiring shareholders to sue in federal court rather than state court. *Salzberg* clarified that corporations could control the forum where securities actions are brought under certain circumstances. The Delaware Supreme Court, however, noted that forum selection provisions wouldn't be valid in all circumstances and that charter and bylaw provisions that may be facially valid would not be enforceable if used for inequitable purposes.

In *Lee v. Fisher*, the Ninth Circuit panel affirmed the lower court ruling and held that plaintiff was bound by Gap's bylaws. In reaching this conclusion, the panel explained that forum selection clauses are enforceable and binding on parties unless a party can demonstrate extraordinary circumstances, such as when (1) the forum selection clause is invalid because of fraud or overreaching, (2) enforcement of the clause would contravene a strong public policy of the forum in which suit is brought or (3) the forum would be so difficult and inconvenient as to deprive the litigant of its day in court. See *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972). Plaintiff did not contend that the forum selection clause is invalid due to fraud, nor that litigating her derivative claim in the Delaware forum would be gravely difficult; instead, the panel considered only the second factor derived from *Bremen* — whether enforcement of the clause would contravene strong public policy. The panel held that plaintiff did not meet her burden to show that enforcing Gap's forum selection clause contravenes federal public policy.

The Ninth Circuit panel's affirmation put it in direct conflict with the Seventh Circuit's decision in *Seafarers Pension Plan v. Bradway*, 23 F.4th 714 (7th Cir. 2022). In *Seafarers*, The Boeing Company defended the enforceability of an identical forum selection clause in its bylaws. The Seventh Company Circuit overturned the lower court's decision to enforce *forum non conveniens*, holding that Boeing could not rely on that forum selection clause to prevent shareholders from bringing federal derivative claims. The Seventh Circuit held that Section 115 of the Delaware General Corporation Law (DGCL) "reject[ed] Boeing's use of its forum bylaw to foreclose entirely plaintiff's derivative action under Section 14(a)." The court also held that Boeing's bylaw violated the Exchange Act's antiwaiver provision.

While the Ninth Circuit panel in *Lee v. Fisher* acknowledged *Seafarers*, it declined to consider DGCL Section 115 because plaintiff had never raised that argument. In addition, the court followed Ninth Circuit precedent holding "the strong federal policy in favor of enforcing forum-selection clauses … supersede[s] antiwaiver provisions in state statutes as well as federal statutes, regardless whether the clause points to a state court, a foreign court, or another federal court." *Yei A. Sun v. Advanced China Healthcare Inc.*, 901 F.3d 1081, 1090 (9th Cir. 2018). The court held that the Exchange Act's antiwaiver provision does not contain a clear declaration of federal policy.

The *en banc* review by the full Ninth Circuit court is primed to reconsider these questions and its ruling will determine whether a circuit split remains.

CORPORATE GOVERNANCE DEVELOPMENTS

Considerations When Adopting or Amending Advance Notice Bylaws

Public companies rely on advance notice bylaws to protect the interests of all shareholders by ensuring a fair process regarding the nomination of director candidates. Advance notice bylaws are, essentially, requirements that shareholders must satisfy to submit valid director nominations for shareholder meetings. Such bylaws require a nominating shareholder to provide certain information about itself, certain associated parties and its director nominees within a reasonable period of time prior to a shareholder meeting. For annual meeting purposes, this window is frequently between 90 and 120 days prior to the anniversary of the previous year's annual meeting.

There is little debate in corporate America over the principle that advance notice bylaws fulfill a valid and reasonable purpose. The DGCL provides no comparable default rules that would apply for corporations that have no advance notice bylaws. As such, in the absence of advance notice provisions, shareholders would be able to nominate and solicit votes for director candidates while providing only the barest of information to the company and other shareholders with little to no warning ahead of the shareholder meeting.

A case presently before the Delaware Chancery Court challenging a corporation's advance notice bylaw amendments, initiated by activist investor Politan Capital Management LP in October 2022, presents two key questions: (1) When is it legal to adopt sophisticated advance notice bylaw amendments and (2) what kinds of advance notice bylaw amendments cross the line from a legal perspective? These are already well-trodden topics in Delaware case law. Delaware courts have afforded corporations ample room to adopt thorough advance notice bylaws, but they have also put limits on this freedom. The evolution of this case law is largely about the contours of these limits, which have depended heavily on the specific facts in the cases.

The defendant in the case is a Delaware corporation that, facing a potential proxy battle with Politan, adopted several of the most aggressive advance notice bylaw provisions considered (and previously dismissed) by shareholder activism defense legal practitioners. These bylaws require that for any shareholder's notice of dissident director nominations to be valid, the shareholder's notice of nominations to the company must identify, among other things, the investment fund's limited partners, all understandings between the fund's limited partners and any of their respective family members and cohabitants, and any plans the fund has to nominate directors at other public companies in the next 12 months.

Time will tell if these bylaw amendments can sustain the court's scrutiny. When companies adopt these types of bylaws, and particularly if they do so in the face of an imminent proxy contest, they run a risk of undermining reasonable and appropriate advance notice bylaws. Companies considering adopting or amending advance notice bylaws should consider the following practical guidance:

The Delaware courts have stated that the clearest set of cases providing support for enjoining an advance notice bylaw involves a scenario in which a board, aware of an imminent proxy contest, adopts an advance notice bylaw so as to make compliance impossible or extremely difficult.

- **Companies should not lose sight of the desirability of adopting or amending advance notice bylaws on a "clear day."** Adopting on a "rainy day" invites the specter of enhanced scrutiny review. Defensive bylaws adopted in the context of an activist campaign are more susceptible to review under a heightened degree of scrutiny.
- **Adopting bylaw amendments that frustrate or preclude altogether shareholders' ability to run a proxy contest increases the likelihood of this more onerous standard of review.** The Delaware courts have stated that the clearest set of cases providing support for enjoining an advance notice bylaw involves a scenario in which a board, aware of an imminent proxy contest, adopts an advance notice bylaw so as to make compliance impossible or extremely difficult.
- **When adopting advance notice bylaws, engage counsel with experience amending corporate bylaws for advance notice provisions.** The considerations for the adoption of various bylaw provisions are rapidly evolving and will continue to do so for the foreseeable future.

For a more comprehensive discussion, see the Shareholder Activism Update available here.

ISS and Glass Lewis Policy Updates for 2023

Institutional Shareholder Services (ISS) and Glass Lewis & Co. (Glass Lewis) have updated their proxy voting policies for shareholder meetings held on or after February 1, 2023 (ISS) or January 1, 2023 (Glass Lewis). This is a brief summary of the most noteworthy changes ISS and Glass Lewis made to their proxy voting policies that apply to U.S. companies.

Notably, ISS and Glass Lewis recommended that shareholders vote in favor of the small number of officer exculpation charter amendment proposals that appeared in proxy statements this fall.

Officer Exculpation

- **Officer Exculpation Charter Amendment Proposals.** In light of a recent amendment to the DGCL permitting corporations to limit or eliminate the personal liability of officers for claims of breach of the fiduciary duty of care by including an exculpation provision in the corporation's charter, ISS updated its policy for 2023 to include a recommendation to vote case-by-case on proposals providing for exculpation provisions in a company's charter considering the stated rationale for the proposed change and other specified factors.

  Glass Lewis will also evaluate officer exculpation charter amendment proposals on a case-by-case basis and will generally recommend voting against such proposals unless the board provides a compelling rationale for the adoption and the provisions are reasonable.

Board Diversity

- **Board Gender Diversity.** For 2023, ISS has revised its policy to remove the one-year grace period for companies not in either the Russell 3000 or S&P 1500 indices. For 2023, ISS will generally recommend voting against nominating committee chairs (or other directors on a case-by-case basis) at *all* companies where there are no women on the board. ISS will make an exception if there was at least one woman on the board at the previous annual meeting and the board commits to return to a gender-diverse status within a year.

  As announced in 2022, Glass Lewis will transition from a fixed numerical approach to a percentage-based approach for board gender diversity in 2023. At Russell 3000 companies, Glass Lewis will generally recommend voting against the nominating committee chair of a board that is not at least 30% gender diverse.
- **Underrepresented Community Board Diversity.** Beginning in 2023, at Russell 1000 companies, Glass Lewis will generally recommend voting against the nominating committee chair of a board with no director from an "underrepresented community" (as defined by Glass Lewis).
- **State Laws on Board Diversity.** Two California state laws mandating gender and underrepresented community diversity on the boards of California-headquartered corporations were struck down as unconstitutional in spring 2022. Those decisions have been appealed, and Glass Lewis clarified that, while it follows the appeal process, it will continue to monitor a company's compliance with state board composition requirements but will not make vote recommendations until further notice.
- **Disclosure of Director Diversity and Skills.** In 2023, Glass Lewis will expand from the S&P 500 to the Russell 1000 its policy to generally recommend voting against the nominating and/or governance committee chair at companies that have not provided proxy statement disclosure in any of the following areas: (1) the board's current percentage of racial/ethnic diversity, (2) whether the board's definition of diversity explicitly includes gender and/or race/ethnicity, (3) whether the board has adopted a policy requiring women and minorities to be included in the initial pool of candidates when selecting new director nominees (i.e., a "Rooney Rule") and (4) board skills disclosure. In addition, beginning in 2023, Glass Lewis will generally recommend voting against the nominating and/or governance committee chair at Russell 1000 companies that have not provided any disclosure of individual or aggregate racial/ethnic minority demographic information.

Overboarding

- **Director Commitments.** Glass Lewis revised its policy on director commitments to establish different thresholds for a director who serves as an executive *officer* of a public company versus an executive *chair*. As revised, in 2023, Glass Lewis will generally recommend that shareholders vote against (1) a director who serves as an executive officer (other than executive chair) of any public company while serving on more than one external public company board, (2) a director who serves as an executive chair of any public company while serving on more than two external public company boards and (3) any other director who serves on more than five public company boards.

Board Accountability and Oversight

- **Director Accountability for Climate-related Issues.** For 2023, ISS will expand the scope of its policy on board accountability on climate to apply globally. Under the updated policy, ISS will generally recommend voting against the incumbent chair of the responsible committee (or other directors on a case-by-case basis) at companies that are significant greenhouse gas (GHG) emitters through their operations or value chain (defined by ISS as those on the Climate Action 100+ Focus Group list) if ISS determines that the company has not taken minimum steps needed to assess and mitigate the company's climate change risks. For purposes of the policy, minimum steps include (1) detailed disclosure of climate-related risks, such as according to the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), and (2) appropriate GHG emissions reduction targets, meaning medium-term GHG reduction targets or Net Zero-by-2050 GHG reduction targets for a company's operations (Scope 1) and electricity use (Scope 2). ISS notes that targets should cover the vast majority of the company's direct emissions.

  For companies with material exposure to climate risk stemming from their own operations (including companies in the Climate Action 100+ Focus Group), Glass Lewis expects thorough climate-related disclosures in line with TCFD recommendations and disclosure of explicit and clearly defined oversight responsibilities for climate-related issues. If these disclosures are absent or significantly lacking, Glass Lewis may recommend voting against the chair of the committee charged with oversight of climate-related issues, or if no committee has been charged with such oversight, the governance committee chair. If the committee chair is not standing for election due a classified board, or based on other factors, including the company's size and industry and its overall governance profile, Glass Lewis may extend its negative vote recommendations to other members of the responsible committee.
- **Board Oversight of Environmental and Social Issues.** In 2023, Glass Lewis will expand from the S&P 500 to the Russell 1000 its policy to generally recommend voting against the governance committee chair of a company that fails to provide explicit disclosure about the board's role in overseeing environmental and social issues.
- **Board Oversight of Cyber Risk.** Glass Lewis views cyber risk as material for all companies and encourages companies to provide clear disclosure concerning the role of the board in overseeing issues related to cybersecurity and how directors are staying up to date on evolving cybersecurity issues. In 2023, Glass Lewis will generally not make vote recommendations on the basis of a company's oversight or disclosure concerning cyber-related issues but may recommend voting against appropriate directors at a company where cyber-attacks have caused significant harm to shareholders and Glass Lewis finds that the disclosure or oversight is insufficient.

Political Spending and Lobbying Congruency

- **Shareholder Proposals on Political Spending and Lobbying Congruency.** Beginning in 2023, ISS will generally recommend voting case-by-case on shareholder proposals requesting greater disclosure from companies regarding the alignment between their political contributions and lobbying efforts and their publicly stated values and policies considering specified factors. Additionally, under its new policy, ISS will generally recommend voting case-by-case on proposals requesting comparison of a company's political spending to objectives that can serve to mitigate material risks for the company, such as limiting global warming.

Proxy Statement Disclosure About Shareholder Proposals

- **Disclosure of Shareholder Proponents.** Glass Lewis will generally recommend voting against the governance committee chair if a company does not disclose in its proxy statement the identity of the proponent (or lead proponent when multiple proponents have submitted a proposal) of any shareholder proposal that may be going to a vote.

SEC DEVELOPMENTS

SEC Adopts Final Compensation Clawback Rules

On October 26, 2022, the SEC adopted final rules relating to the recovery of erroneously awarded incentive-based executive compensation also known as the "clawback" rules. The long-awaited rules implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The rules direct the national securities exchanges to establish listing standards that require issuers to adopt, disclose and comply with a written compensation clawback policy as a condition to listing securities on a national securities exchange. The policy would apply in the event the issuer is required to prepare an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement under the securities laws. The policy must mandate the recovery of any incentive-based compensation awarded to a current or former executive officer in excess of compensation that would have otherwise been received during the three-year period preceding the date the issuer is required to prepare an accounting restatement. The policy must include a "no fault" recovery mandate, meaning it would apply even if an executive officer (or any other person) did not engage in misconduct and if the executive officer had no responsibility for the financial statement errors that resulted in the restatement.

Importantly, the final rules clarify that a triggering restatement includes both (1) restatements that correct errors that are material to previously issued financial statements ("Big R" restatements) and (2) restatements that correct errors that are not material to previously issued financial statements but would result in a material misstatement if (x) the error was not corrected in the current report or (y) the error correction was recognized in the current period ("little r" restatements). In addition, the rules require listed issuers to provide additional disclosure regarding the operation of the policy, including whether any restatements triggered its use during the reporting period, as well as to file their clawback policies as an exhibit to their annual reports.

In a significant change from the rules the SEC proposed in 2015, the final rules clarify that both "Big R" restatements and "little r" restatements could trigger a required clawback.

The final rules were published in the *Federal Register* on November 28, 2022. February 26, 2023 is the deadline for the stock exchanges to propose listing standards implementing the final rules and November 28, 2023 is the deadline for the stock exchanges' final listing standards to become effective. Listed issuers will have 60 days from the effective date of the final listing standards, which would be January 27, 2024 at the latest, to adopt a compliant clawback policy. An issuer must file its clawback policy and make related disclosures in its first annual report or proxy statement after the effective date of the new listing standards.

Companies should evaluate their existing clawback policies to determine whether they are in line with the mandates of the final rules and socialize any expected changes with their boards. Given the inclusion and potential frequency of little r restatements, companies may wish to analyze prior little r restatements to inform the board of what the historical impact of the rules would have been to give boards a sense of the practical implication of the rules. In addition, in light of the potential for recovery and the inability to waive recovery, issuers should consider whether they may need to develop processes for recovery of compensation in the event of a restatement. As always, establishment of solid internal controls related to financial reporting is imperative to reduce the likelihood of any restatement. For more information, see the Sidley Update available here.

SEC Adopts Significant Changes to Rule 10b5-1 Trading Regime and Related Disclosures

The SEC has significantly altered a safe harbor that company officials and others rely on to avoid potentially illegal insider trading. On December 14, 2022, the SEC unanimously adopted amendments to Exchange Act Rule 10b5-1 that effectively narrow the affirmative defense to insider trading liability under Rule 10b5-1(c)(1) by adding new conditions such as a 90-to-120-day cooling-off period before any plan trades and limits on overlapping and

single-trade plans. In addition, the amendments impose new disclosure requirements on public companies regarding officer and director plans, insider trading policies and the timing of certain stock awards. Finally, the amendments alter Section 16 reporting requirements, including by requiring additional disclosure regarding Rule 10b5-1 transactions and earlier reporting of stock gifts.

The final rules are effective 60 days after publication in the *Federal Register*, which under normal publication timeframes would mean the rules would take effect in late February 2023. The new conditions will not apply to existing plans or plans entered into prior to the effective date. The disclosure requirements will apply to Forms 10-Q, 10-K and 20-F and to proxy and information statements in the first filing that covers the first full fiscal period beginning on or after April 1, 2023 (October 1, 2023 for smaller reporting companies). Section 16 filers will be required to use amended Forms 4 and 5 for beneficial ownership reports filed on or after April 1, 2023.

New Conditions to the Availability of the Rule 10b5-1(c)(1) Affirmative Defense to Insider Trading Liability

Officers, directors and other insiders (but not issuers themselves) wishing to rely on the affirmative defense to insider trading liability under Rule 10b5-1(c)(1) will have to comply with additional conditions after the effective date of the new rules. These conditions include the following:

- *Good Faith.* To be eligible for the affirmative defense, directors, officers or other insiders must not only have entered into the Rule 10b5-1 plan in good faith but must also act in good faith with respect to any contract, instruction or plan they adopt.
- *Cooling-Off Periods.* Trades may not be made during a cooling-off period of:
  - For directors and officers, the later of (1) 90 days after adoption of the plan or (2) two business days following disclosure of the issuer's financial results in a Form 10-Q or Form 10-K for the completed fiscal period in which the plan was adopted, or, for foreign private issuers, in a Form 20-F or Form 6-K that discloses the issuer's financial results (not to exceed 120 days); or
  - For insiders other than directors or officers, 30 days after adoption of the plan.
- *Representations.* Directors and officers must include a representation in their Rule 10b5-1 plans that at the time of adopting or modifying a plan they are not aware of any material nonpublic information and are adopting the plan in good faith.
- *Overlapping Plans.* Insiders may not use multiple overlapping Rule 10b5-1 plans for transactions on the open market, with the following exceptions:
  - A series of separate contracts with different broker-dealers or agents that, when taken as a whole, effectively function as a single "plan" and meet the applicable conditions of the rule;
  - One plan under which trading is authorized to begin only after all trades under an earlier-commencing plan are completed or expired; and
  - A plan providing for an agent to sell securities only as necessary to satisfy tax withholding obligations arising exclusively from the vesting of a compensatory award.
- *Single-Trade Plans.* Insiders may rely on the affirmative defense for only one single-trade plan within any consecutive 12-month period.

Enhanced Disclosure Requirements

Companies and Section 16 filers will be subject to additional disclosure requirements and expedited disclosure timing in certain circumstances.

Companies may wish to revisit their Rule 10b5-1 plans and insider trading policies and procedures, considering what processes and disclosures must be added to comply with the new rules, particularly the cooling-off periods.

- Issuers must, on a quarterly basis, provide disclosure regarding their use of Rule 10b5-1 plans and certain other written trading arrangements by their directors and officers for the trading of their securities.
- Issuers must annually disclose their insider trading policies and procedures.
- Issuers must provide certain tabular and narrative disclosures of the grant of options to named executive officers made during the period starting four business days before the filing of a periodic report on Form 10-Q or Form 10-K or a Form 8-K disclosing material nonpublic information (including earnings information) and ending one business day after such filing.
- Certain disclosures must be tagged.
- Section 16 filers must report dispositions of shares via a bona-fide gift on a Form 4 within two business days of a transaction rather than annually on Form 5. Forms 4 and 5 will also include a box for filers to check indicating whether the transaction was made pursuant to a plan intended to satisfy the conditions of the Rule 10b5-1 affirmative defense, and the reporting person will need to disclose the date of the adoption of the Rule 10b5-1 plan. In our view, the terms "trade" and "sale" in Rule 10b5-1(c)(1) include bona fide gifts of securities.

Companies may wish to revisit their Rule 10b5-1 plans and insider trading policies and procedures, considering what processes and disclosures must be added to comply with the new rules, particularly the cooling-off periods. Additionally, companies may want to consider offering training on the new rules to their officers, directors and other insiders. For more information, see the Sidley Update available here.

New Guidance Illustrates SEC's Continued Scrutiny of Non-GAAP Reporting

On December 13, 2022, the staff of the SEC's Division of Corporation Finance updated its Compliance & Disclosure Interpretations (CDIs) relating to the use of non-GAAP financial measures, which have been a continual focus of SEC scrutiny. The new and updated CDIs are available here and summarized below.

Prominence of Non-GAAP Measures

- **Revised Question 102.10(a).** Whether a non-GAAP measure would be considered more prominent than the most directly comparable GAAP measure depends on the facts and circumstances and also applies to any discussion and analysis of the non-GAAP measure. The staff added two new examples of non-GAAP measures it would consider more prominent than the comparable GAAP measures: (1) presenting a ratio where a non-GAAP financial measure is the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measures and (2) describing a non-GAAP measure as "record performance," "exceptional" or similar without at least an equally prominent descriptive characterization of the comparable GAAP measure.
- **New Question 102.10(b).** The staff provided three examples of disclosures that would cause a non-GAAP reconciliation to give undue prominence to a non-GAAP measure: (1) starting the reconciliation with a non-GAAP measure, (2) presenting a non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures and (3) when presenting a forward-looking non-GAAP measure, failing to (x) disclose reliance on the exception to providing a quantitative reconciliation and (y) identify the information that is unavailable and its probable significance in a location of equal or greater prominence.
- **New Question 102.10(c).** The staff believes that presenting a non-GAAP income statement, either alone or as part of a required non-GAAP reconciliation, gives undue prominence to non-GAAP measures. The staff clarified that it deems a non-GAAP income statement to be one comprised of non-GAAP measures and including all or most line items and subtotals found in a GAAP income statement.

Companies that use non-GAAP measures in their public filings should review and comply with the new CDIs and continue to focus on transparency and prominently featuring GAAP measures.

Potentially Misleading Non-GAAP Measures

- **New Question 100.01.** Even adjustments that are not explicitly prohibited may nevertheless cause a non-GAAP measure to be misleading in violation of Rule 100(b) of Regulation G depending on the company's individual facts and circumstances. For example, presenting a non-GAAP performance measure that excludes normal, recurring, cash operating expenses necessary to operate the company's business may be considered misleading depending on the nature and effect of the non-GAAP adjustment and how it relates to the company's operations, revenue-generating activities, business strategy, industry and regulatory environment. The staff clarified that it views an operating expense as recurring if it occurs repeatedly or occasionally, including at irregular intervals.
- **Revised Question 100.04.** Non-GAAP adjustments that have the effect of changing the recognition and measurement principles required to be applied in accordance with GAAP would be deemed individually tailored and may cause a non-GAAP measure to be misleading. The staff provided examples of adjustments it may consider misleading that involved accelerating revenue recognition, presenting a revenue measure on a gross rather than net basis and changing from the accrual to cash basis of accounting.
- **New Question 100.05.** A non-GAAP measure could be misleading if not appropriately labeled and clearly described, including by (1) failing to describe a measure as non-GAAP or (2) using a label that does not reflect the nature of the non-GAAP measure (e.g., labeling as "net revenue" a contribution margin that is calculated as GAAP revenue less certain expenses or labeling a measure "pro forma" that is not calculated in a manner consistent with Article 11 of Regulation S-X).
- **New Question 100.06.** A non-GAAP measure could mislead investors even if it is accompanied by extensive, detailed disclosure about the nature and effect of each adjustment made to the most directly comparable GAAP measure.

Companies that use non-GAAP measures in their public filings should review and comply with the new CDIs and continue to focus on transparency and prominently featuring GAAP measures.

SIDLEY RESOURCES

M&A

2023 M&A Outlook: Q&A with Twelve Top Global M&A Dealmakers (Dec. 19, 2022). Twelve top Global M&A Dealmakers discuss predictions for the year ahead. Brian Fahrney, co-head of Sidley's Global M&A and Private Equity practice, discusses the global dealmaking market, including financing challenges and regulatory hurdles on the horizon.

ESG

DOL Issues Final Rule on Consideration of ESG Factors and Exercise of Shareholder Rights by Retirement Plan Fiduciaries (Dec. 1, 2022). On November 22, 2022, the U.S. Department of Labor released a final rule under the Employee Retirement Income Security Act that empowers plan fiduciaries to consider climate change and other ESG factors when making investment decisions and exercising shareholder rights, such as proxy voting.

Proposed Climate Disclosure Requirements for Federal Contractors Go Beyond the SEC's Proposed Disclosures (Nov. 16, 2022). On November 10, 2022, the federal government proposed a rule that would impose broad climate-related disclosure requirements on government contractors through amendments to the Federal Acquisition Regulations. The unprecedented proposal is more expansive than the SEC's proposed disclosure rule, as major federal contractors would not only have to disclose GHG emissions but also set specific GHG emissions reduction targets — targets that would have to be validated by a third party. If finalized, contractors subject to these requirements that do not provide the

required disclosures may be disqualified from future federal procurement contracts. Comments on the proposal are due by January 13, 2023.

Antitrust

The U.S. Department of Justice May Clamp Down on Life Sciences Companies That Share Board Members With Alleged Competitors (Nov. 28, 2022). The Biden administration is conducting investigations into potential antitrust violations to which the life sciences industry may be particularly vulnerable because having board members sit on more than one company is relatively common.

November Sidley Antitrust Bulletin: Top-of-Mind Global Antitrust Issues (Nov. 22, 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. The U.S. antitrust agencies have continued to try to expand antitrust enforcement. The Antitrust Division of the DOJ made news when it recently obtained a guilty plea in a criminal monopolization case for the first time in decades, and the U.S. Federal Trade Commission (FTC) issued a new policy statement regarding its intention to use its Section 5 "unfair methods of competition" authority. Across the Atlantic, the European Commission (EC) is also revising the public guidance regarding some of its practices, and it just started a public consultation on the revision of its Market Definition Notice. With respect to U.S. enforcement, the DOJ has been embracing theories of harm relating to buyer power, including through its investigations into labor issues and in recent merger litigation. Also with respect to labor, DOJ secured a guilty plea in a criminal wage-fixing and no-poach case at the end of October.

October Sidley Antitrust Bulletin: Top-of-Mind Global Antitrust Issues (Oct. 25, 2022). Both the U.S. FTC and the DOJ have started to pursue areas of the antitrust law that have received less standalone attention from the agencies in recent decades, as the FTC discusses enforcing the Robinson Patman Act (which prohibits certain price discrimination) and the DOJ invests resources into enforcing against interlocking directorates. But while the U.S. agencies are branching out with their enforcement efforts, the U.S. courts are making it clear that a change in enforcement priorities and style does not necessarily mean a change in the law when it comes to mergers. Like the DOJ, the UK Competition and Markets Authority has renewed its focus on individual board members, with further examples of director disqualifications being sought where there has been a breach of competition law. And the EC recently issued a revised informal guidance notice allowing companies to request informal guidance on a broader range of conduct.

SIDLEY SPEAKERS

M&A Trends & Developments

January 30 - February 1 | Coronado, CA

Sharon Flanagan, the office managing partner of Sidley's San Francisco office and a member of the firm's Management Committee and Executive Committee, will chair a panel titled *M&A Trends and Developments* at the Northwestern Pritzker School of Law's 50th Annual Securities Regulation Institute on January 31. Click here for more information.

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