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ANALYSIS

THE NEW AUDITOR'S REPORT: HOW TO RESPOND

By Thomas J. Kim[1]

On October 23, 2017, the SEC approved the PCAOB's rule proposal to adopt Auditing Standard No. 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (AS 3101). The purpose of this new standard is to make the auditor's report "more useful and informative to investors,"[2] principally by requiring the auditor to describe any "critical audit matters" or "CAMs" in its audit report. A CAM is any matter arising from the audit that was communicated or required to be communicated to the audit committee[3] and that relates to accounts or disclosures that are material to the financial statements and involved "especially challenging, subjective or complex auditor judgment."

For a more detailed summary of what will be required in the new auditor's reports, see our Sidley Update, available here.

In determining whether a matter involved especially challenging, subjective or complex auditor judgment, AS 3101 directs the auditor to take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

- The auditor's assessment of the risks of material misstatement, including significant risks;
- The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;
- The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;
- The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;
- The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and
- The nature of audit evidence obtained regarding the matter.

AS 3101 will require not only a description of the CAM, but also of the principal considerations that led the auditor to determine that the matter is a CAM and how the CAM was addressed in the audit and affected relevant financial statement accounts or disclosures. Although the auditor can conclude that no CAMs arose in the course of the audit, the PCAOB expects the auditor to include "at least one" CAM in its audit report.[4]

On the one hand, the SEC's approval of the PCAOB's rule proposal four months later should not have been a surprising development. After all, the SEC and its Staff oversee the PCAOB's activities (and with a stronger hand than before the 2010 Supreme Court decision[5] affirming the constitutionality of the PCAOB, provided that its members can be removed at will by the SEC), and the SEC allowed the PCAOB to approve AS 3101 on June 1, 2017. Why would the SEC have allowed this vote to happen if the SEC did not also anticipate that it would subsequently approve AS 3101?

On the other hand, to many observers, the SEC's approval was a surprise. During the SEC's notice and comment period for AS 3101, many commenters expressed concern that AS 3101 could have unintended adverse consequences. Specifically, among other examples:

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2 PCAOB Release No. 2017-001 (June 1, 2017)(PCAOB Release) at 20.

3 In general, Auditing Standard No. 1301.24 requires the auditor to communicate matters arising from the audit that are significant to audit committee oversight of the financial reporting process. Other Auditing Standards require the disclosure of certain specific information to the audit committee.

4 PCAOB Release at 37.

5 *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 561 U.S. 477 (2010).

- By defining a CAM as a matter that was discussed or was required to be discussed with the audit committee, AS 3101 would inevitably chill or even inhibit free and open communications between the auditor and the audit committee. In addition to concerns about once private matters being subject to public disclosure as CAMs, each matter discussed with the audit committee, if it related to accounts or disclosures that are material to the financial statements, would now be subject to additional internal documentation requirements. If the auditor determines that the matter does not rise to the level of a CAM, notwithstanding the fact that it was important enough to be communicated to the audit committee, then the auditor must document the basis for this determination. As a result, it would not be surprising if the number of matters discussed between the auditor and audit committee decreases once AS 3101 is in effect.
- By requiring the auditor to disclose how the CAM was addressed in the audit, and by including the "nature and extent of audit effort required to address the matter" and the "nature of audit evidence obtained regarding the matter" as factors to consider in determining whether a matter rises to the level of a CAM, AS 3101 would likely result in the auditor disclosing new information about the issuer that the issuer would not itself be required to disclose,[6] including information about significant deficiencies in internal control over financial reporting—thereby changing the role of the auditor from attester of the issuer's financial information to author of new information about the issuer.
- In response, to provide context for the auditor's disclosure of CAMs, issuers would likely feel compelled to provide reactive (and possibly immaterial) disclosures, resulting in added burdens and costs to issuers and their audit committees, with no corresponding benefit to investors.

AS 3101 could adversely affect current audit and governance processes with respect to financial reporting.

In short, AS 3101 could adversely affect current audit and governance processes with respect to financial reporting.

In addition to these substantive concerns, it is notable that (i) AS 3101 is the work product of a PCAOB led by a Chairman appointed during the Obama Administration; (ii) AS 3101 reflects a globalist perspective—in its rulemaking release, the PCAOB pointed out that several international regulators and standard setters, including the International Auditing and Assurance Standards Board, the European Union and the Financial Reporting Council in the United Kingdom, adopted expanded auditor reporting requirements that share a common theme with AS 3101, namely, communicating information about audit-specific matters in the auditor's report;[7] (iii) SEC Chairman Clayton was sworn into office on May 4, 2017, less than a month before the PCAOB's vote to approve AS 3101; and (iv) at the time of consideration, there were (and continue to be) two vacancies on the SEC. In view of this context and the current political climate, it would not have been surprising if, by October 2017, the SEC had decided to disapprove AS 3101 on the basis that further study and review was warranted and by a full five-member SEC. After all, there was no legislative mandate to implement AS 3101 and no deadline to meet.

In any event, AS 3101 was approved. For large accelerated filers, AS 3101's CAM disclosure requirements will take effect for audits of fiscal years ending on or after June 30, 2019, and for all other registrants, for audits of fiscal years ending on or after December 15, 2020. Other requirements of AS 3101, including required changes to the auditor's report that are primarily intended to clarify the auditor's role and responsibilities,[8] will take effect for all audits of fiscal years ending on or after December 15, 2017.

So, what should audit committees, engagement partners and their audit firms do now?

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6 After all, neither Regulation S-K nor Regulation S-X requires any disclosure about the audit process itself. AS 3101.14, Note 2 expressly acknowledges that disclosure of information not otherwise required to be disclosed may occur.

7 PCAOB Release at 7-11.

8 For example, the length of the auditor's tenure, a new statement about the auditor's independence and adding shareholders to the list of addressees of the report are among the types of new information required to be included in the audit report.

The "Reasonable" Auditor

Calendar year filers will have two audit periods (2017 and 2018) in which audit committees and their engagement partners and audit firms can discuss the CAM disclosure requirements and apply them to actual audit matters without having to publicly disclose any matters that rise to the level of CAMs. We recommend that all public companies and their audit firms engage in this exercise for the 2017 audit period to begin sharing views as to which audit matters involve "especially challenging, subjective or complex auditor judgment."

Sharing views will be particularly important because the "especially challenging, subjective or complex auditor judgment" disclosure standard is unique in the auditing standards literature and in the federal securities laws generally. Unlike "materiality" or "reasonableness," this does not appear to be an objective standard. Commenters expressed concern that this standard was "broad and subjective" and that an auditor's CAMs "would vary based on the experience and competence of the auditor, even if the underlying facts and circumstances were the same."[9] The PCAOB clearly considered these comments, since it chose to quote them in its rulemaking release, but nevertheless decided to adopt the standard as proposed, in order to "ground[] the definition in the auditor's expertise and judgment, which is directly responsive to investor requests for information from the auditor's point of view."[10] Although the PCAOB did not characterize this disclosure standard as being objective or subjective, the PCAOB concluded its discussion of this standard by noting that, "[t]o the extent that critical audit matters might reflect differences in auditors' experience and competence, this in itself should also be informative"[11]—a nod to the view that it is a subjective standard.

If CAMs are intended to reflect the individual engagement partner's experience and competence, then this personal approach to CAMs would be consistent with the other significant and controversial rulemaking that the PCAOB adopted under Chairman Doty's leadership: PCAOB Rule 3211, *Auditor Reporting of Certain Audit Participants*, which requires audit firms to publicly disclose, on Form AP, the name of the engagement partner for a particular company's audit. The rationale for this requirement is that "[i]nvestors and others will know who is leading and participating in audits through these filings, adding more specific data points to the mix of information that can be used when evaluating audit quality."[12]

Notwithstanding the PCAOB's apparent emphasis on the specific auditor's experience and competence, in our view, to the extent possible, audit committees should insist that their engagement partner and engagement team apply the CAM disclosure requirement in a manner that is as objective as possible. This disclosure requirement should elicit information from the "reasonable auditor's point of view," and not the actual engagement partner's or team's personal point of view. Neither issuers nor investors would benefit from disclosures of CAMs that overstate the significance or importance of a particular audit matter because the engagement partner or engagement team lacked the relevant experience or competence to appropriately judge the difficulty or complexity involved.

We would also expect that between now and 2020, the audit firms, particularly the major audit firms, will develop their own sets of policies, procedures and practices, such as review by the firm's national office, supplemented by training, to promote consistency in the manner in which their thousands of audit engagement partners apply the CAM disclosure requirements. They may also develop their own vocabulary or standard phrases for describing CAMs—for risk mitigation purposes, if nothing else. After all, the PCAOB

9 PCAOB Release at 21.

10 *Id.* at 22.

11 *Id.*

12 This is from the PCAOB's home page for Form AP reports: https://pcaobus.org/Pages/form-ap-reporting-certain-audit-participants.aspx.

candidly acknowledges that the disclosure of CAMs will subject the auditor to potential liability under Exchange Act Section 10(b) as well as Securities Act of 1933 Section 11.[13]

The PCAOB Staff issued implementation guidance on December 4, 2017, including an annotated example of a new auditor's report.

Now that AS 3101 has been approved, there is much work to be done to implement it responsibly. Notwithstanding the PCAOB's "this in itself should also be informative" attitude, audit committees should demand the application, to the extent possible, of the objective, reasonable auditor perspective to the CAM disclosure requirement—in other words, never mind who the engagement partner happens to be for this audit period, would the reasonable auditor view the audit matter as involving "especially challenging, subjective and complex auditor judgment"? Correspondingly, audit firms should understand that it is very much in their interest to do so.

GOVERNING THROUGH DISRUPTION: BOARD PRIORITIES FOR 2018

By Holly J. Gregory[14]

Boards of directors govern in an increasingly dynamic environment marked by technological and business model disruption, regulatory and enforcement uncertainty, political unrest and expanding expectations about the company's role in addressing societal problems. Innovative uses of technology drive changes in competitive conditions, create opportunities for inventive companies, and hurt those that are slow to adapt. Interrelated changes in consumer behavior, customer expectations, the supply chain, and the labor market add complexity to governance, as does the social and political unrest that often emerges in transformational times.

These issues will impact the board's agenda and priorities in 2018, as companies seek to identify opportunities arising from disruption and avoid unexpected risks, and as shareholder activists continue their efforts to influence corporate decisions. While the challenges facing boards change over time, the responsibilities of the board and the fiduciary duties of directors under state corporate law remain stable, namely:

- The board is the body empowered to direct the company's affairs, and shareholders lack the power under law, and as a practical matter, to govern by referendum.
- Acting with due care, without a conflict of interest, in good faith and in the best interest of the company continues to be the legal standard by which director action (or inaction) is generally assessed.

While each board must define its own priorities based on the unique circumstances facing the company, this article outlines the key areas on which boards are likely to focus in 2018, including:

- Oversight of strategic planning to create long-term sustainable value;
- Risk management and crisis preparedness;
- Management delegation, performance, compensation and succession;
- Effective engagement with shareholders, including activists;
- Board succession planning aligned with changing circumstances; and
- Corporate culture and related controls.

Oversight of Strategic Planning

Oversight of the long-term strategy of the business and related risks is a central board activity that should account for a significant portion of the board's meeting time. To guide

13 PCAOB Release at 40-44.

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corporate strategy and oversee management's performance in a fast-moving time of technological change, the board needs to be technologically savvy and open to change, whether through organic means (e.g., R&D) or acquisition of technology and disrupters.

The board should pay special attention to long-term investment and prudent risk-taking in the face of significant short-term pressures for immediate returns, or other conflicts. This includes:

- Supporting a focus on long-term strategy;
- Approving the strategic and operating plans and related budgets, after active iteration with management and deliberation; and
- Monitoring management's performance using preset benchmarks where possible to determine progress in relation to strategic and operating plans and budgets, and to help provide an "early warning" when a change in strategy is needed.

The board's oversight of strategic planning is particularly important because investors are focused on long-term sustainable value creation as demonstrated in recent letters to portfolio company directors from the CEOs of BlackRock, Inc., State Street Global Advisors and The Vanguard Group, Inc.

Risk Management and Crisis Preparedness

The board plays a key role in assisting management to (i) understand and focus on the risks associated with corporate strategies and the ever-changing business and political environment, (ii) determine the company's risk appetite and (iii) devote appropriate resourcing to risk identification and management activities. Prudent risk-taking requires reliable risk-reward information, which should take into account the key risks associated with the drivers of corporate performance.

Key risks that should be of the greatest concern for most boards are those associated with cybersecurity, data protection, legal compliance and corporate culture.

Identifying and understanding emerging and future risks can be difficult. Boards can also miss the true nature of a risk, for example, by failing to consider the potential reputational damage of a risk that may have little quantitative impact. Key risks that should be of the greatest concern for most boards are those associated with cybersecurity, data protection, legal compliance and corporate culture. An emerging risk to consider relates to taking a public position (or not taking a public position) on political and social issues.

Issues that ultimately impact corporate reputation can sometimes fail to be noticed at the management level and come to the board's attention when it is too late to avert a crisis. The board and management should take steps to plan for a crisis to position the company to react quickly. Board action items may include:

- Determining with management the level of risk exposure that the company is willing to accept with regard to its strategy and operations;
- Monitoring management's efforts and the processes and controls related to the identification, review, management and mitigation of risk;
- Understanding significant risks to the business and how the company is prepared to respond (including periodically reviewing plans for responding to natural disasters, broad failures of the power grid and cybersecurity breaches);
- Understanding management's efforts to prepare for a crisis, and being ready to become actively involved in circumstances in which management may be conflicted; and
- Ensuring the board can act effectively when a crisis occurs by embracing governance practices that support a board culture in which consensus can be readily achieved after full and informed discussion, independent viewpoints are respected and valued and confidentiality is protected.

Management Delegation, Performance, Compensation and Succession

Boards typically delegate day-to-day management of the company to the CEO and other corporate officers and, as fiduciaries, may reasonably rely on these officers to perform the delegated tasks. Continuing assessment of the reasonableness of the board's delegation is central to the board's oversight role.

2018 is the first year in which CEO pay ratio disclosure will be required, and boards will need to be prepared to address any adverse reactions from employees, shareholders and the media.

While directors may be tempted to overstep into management's purview and function at a level similar to corporate officers, directors who do so may lose the ability to take advantage of the exculpatory provision typically included in the company's certificate of incorporation (e.g., DGCL Section 102(b)(7)).

Key areas of board focus include:

- Selecting the CEO and clearly articulating the CEO's authority and performance expectations;
- Monitoring the performance of the CEO and executive officers and continually assessing whether reliance on these key executives is reasonable;
- Advising and coaching management, as appropriate, by providing management with the benefit of the board's collective expertise, but not by dictating actions that are clearly within management's purview;
- Planning for succession of the key executive officers under both normal and emergency circumstances;
- Replacing the CEO when the circumstances warrant; and
- Determining appropriate incentives to attract and retain leaders and to align the efforts of key executives with performance expectations, being mindful of how CEO pay compares not only to peers, but also to median employee compensation.

Engagement with Shareholders

The Investor Stewardship Group (ISG) issued a press release on December 5, 2017 encouraging companies to disclose in their 2018 proxy statements how their governance structures align with (or deviate from) the ISG Framework.

Views on corporate governance are converging in several key areas as institutional shareholders expand their influence on the governance of U.S. public companies. For example, corporate governance recommendations issued by groups such as the Investor Stewardship Group, the National Association of Corporate Directors and signatories to the Commonsense Principles of Corporate Governance emphasize the need to align board composition with strategic direction, factor sustainability considerations into corporate decisions and resist short-term pressures.

Shareholder activism has long been the province of public pension funds and a few individual shareholders who have pushed to expand shareholder rights through shareholder proposals and negotiated settlements. In the last decade, hedge fund activists have influenced board decisions through more pointed efforts to replace management or obtain board seats. Large index funds are increasingly engaging with companies through letter-writing campaigns and by issuing policy statements that emphasize investors' priorities and areas of focus.

In this dynamic environment, it is in the interests of the company for the board to:

- Actively oversee engagement with key shareholders, which should occur on a regular basis and emphasize learning about shareholders' viewpoints and developing enduring relationships;
- Periodically review the company's engagement efforts to determine what is working well and which processes could be improved, and what the company should disclose about its engagement processes and actions taken in response to shareholder feedback;
- Seek to understand how various shareholders' perspectives differ based on their divergent interests;

- Consider and address, as appropriate, shareholder requests and proposals;
- Stay informed of the perspectives of proxy advisors (without assuming that they necessarily reflect the views of the company's shareholders);
- Consider how various types of shareholder activists are likely to view the company—and its strategies and governance and compensation practices—with a focus on identifying vulnerabilities (e.g., CEO pay ratio disclosure);
- Have a plan for responding to a shareholder activist approach that includes studied consideration of the shareholder activist's views;
- Consider whether the company should enhance its disclosures relating to corporate strategy, particularly where the company perceives it may be vulnerable to a shareholder activist attack in relation to its strategy; and
- Continue to apply informed and objective judgment.

Engagement should foster a relationship of trust with key shareholders who may be more willing to support the board and management in the face of a shareholder proposal, proxy access nomination or proxy contest.

Board Succession Planning

The quality of board governance begins with the composition of the board. Boards need highly competent and committed directors with a combination of expertise relevant to the company's business and direction. Competency and relevancy of expertise are key issues that shareholder activists focus on, and these are also the likely focus for future use of proxy access.

Specific areas for board activity include:

- Recruiting highly qualified directors with relevant expertise and the ability to commit the requisite time, taking into account diversity considerations;
- Considering board refreshment mechanisms, including age and tenure limits and individual director evaluation (through self-assessment or peer review);
- Avoiding treating the re-nomination decision as a foregone conclusion, and instead basing re-nomination decisions on the assessment applied when recruiting directors, as well as assessment of their actual performance;
- Evaluating and attending to issues of board and committee leadership, ensuring that leadership is in place to provide a strong, albeit generally supportive, counterweight to management;
- Organizing the work of the board, including determining board and committee agendas and information needs and taking care to ensure that the most important matters receive priority attention;
- Attending to board culture, including processes designed to encourage the expression of diverse views while also ensuring that consensus is developed efficiently;
- Providing compensation for directors that fairly reflects the time and effort that is required of them;
- Evaluating and discussing board and committee effectiveness, and the effectiveness of board and committee leaders, on an annual basis. The board should consider evaluation of individual directors either as a component of the board evaluation or as a component of re-nomination decisions (or both), and should consider what to disclose about the evaluation process; and
- Staying abreast of emerging ideas about best practice trends developing in the proxy season with shareholder proposals and proxy advisor policies.

Two recent publications of the National Association of Corporate Directors and the Association of Corporate Counsel discuss how chief legal officers are uniquely positioned to partner with boards to influence corporate culture.

Corporate Culture and Related Controls

Internal controls and the compliance and ethics program help set the tone for corporate culture and continue to be an important area for board attention (often through the audit committee). To set the right "tone at the top," boards need to:

- Attend to the corporate culture, emphasizing expectations that management and employees will abide by and promote within the company ethical behavior, fair dealing and integrity;
- Understand and oversee the internal controls and procedures that management has put in place to assure that financial reporting is accurate and the company complies with applicable law and regulation;
- Oversee management's efforts to educate personnel about the corporate code of conduct and expected standards of ethical behavior, encourage internal reporting (whistleblowing), monitor compliance and identify and respond as appropriate to red flags or a series of yellow flags;
- Pay special attention to related-person transactions and other conflicts of interest that involve members of the board or senior management;
- Attend to issues of, and set standards and policies regarding, sustainability and social responsibility, including environmental issues, involvement in the political arena and human rights;
- Ensure that information and reporting systems and related investigation processes are designed to identify wrongdoing and wrongdoers; and
- Emphasize that compliance is strategically important and essential for achieving business priorities, and that everyone has personal responsibility for compliance.

NEWS[15]

JUDICIAL DEVELOPMENTS

Companies Allowed to Include Incorporation by Reference Condition on DGCL Section 220 Document Productions

The Delaware courts encourage stockholder plaintiffs to seek applicable corporate books and records under Delaware General Corporation Law (DGCL) Section 220 prior to filing a derivative complaint. Plaintiffs are encouraged to seek these records in order to file a first-round complaint that satisfies the pleading standards, and the Court of Chancery will dismiss complaints that are inadequately pled. In responding to Section 220 demands, companies often require certain limitations, such as confidentiality agreements which restrict the use of produced records or venue selection provisions for subsequent litigation based on the produced records. Recently responding companies have requested that demanding stockholders also agree that all documents produced in response to a Section 220 demand will be considered incorporated by reference into any subsequent derivative complaint. An incorporation condition allows defendants to reference, and the Court to consider, all of the produced documents and not simply those documents that the plaintiff has elected to reference in the complaint. Without such a provision, a motion to dismiss is restricted to the face of the complaint, documents specifically referenced and those of which the Court may take judicial notice. Section 220(c) grants the Court of Chancery discretion to impose "conditions as the Court deems appropriate" on a Section 220 document production.

15 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Justin R. Becker, Sara B. Brody, Jennifer F. Fitchen, Jarrett H. Gross, Claire H. Holland, John K. Hughes, Marc A. Korman, Kelly L.C. Kriebs, James Mendenhall, Hannah Posen, Mark D. Schneider and Gabrielle Whitehall.

Vice Chancellor Laster first ordered an incorporation condition in *Amalgamated Bank v. Yahoo! Inc.* (Del. Ch. Feb. 2, 2016). In a series of decisions this year, the Court of Chancery has continued to allow responding companies to require incorporation as a condition of responding to a Section 220 demand. See *Elow v. Express Scripts Hldg. Co.* (Del. Ch. May 31, 2017); *In re Plains All Am. Pipeline, LP Unitholders Books and Records Litig.* (Del. Ch. Aug. 8, 2017) (Order). A recent Memorandum Opinion by Vice Chancellor Glasscock in *The City of Cambridge Retirement System v. Universal Health Services, Inc.* (Del. Ch. Oct. 12, 2017) further analyzed the competing arguments on this issue and found in favor of permitting the responding company to require this restriction.

In the *City of Cambridge* opinion, the stockholder plaintiff objected to the condition on the ground that the responding company could withhold harmful documents, producing only a self-selected set that could be used to support dismissal. Vice Chancellor Glasscock acknowledged the risk that an incorporation condition could make it easier for a defendant to withhold harmful documents in bad faith and avoid getting caught if the subsequent derivative case is dismissed. But the Vice Chancellor found that the efficiency gains from dismissing derivative complaints that rely on documents taken out of context outweigh the risk of defendant misconduct. The opinion further noted that an incorporation condition does not alter the standard of review on a motion to dismiss, which provides that inferences are drawn in plaintiff's favor and that "the plaintiff continues as the master of her complaint."

City of Cambridge continues the line of cases upholding a responding company's requirement of an incorporation condition in connection with producing documents in response to a Section 220 demand. Including an incorporation condition is a useful tool in moving to dismiss a derivative complaint, as it allows defendants to reference all the documents in the Section 220 production and not limit consideration to those documents selected by plaintiff.

Delaware Court of Chancery Denies DGCL Section 220 Demand when Stockholder Failed to Prove a Current Need for the Requested Information

The Court noted that if a proper purpose is established, "the fact that a secondary purpose may also prompt the demand for inspection is irrelevant." This is not expanded upon in the decision, but it is possible the Court was signaling that the value of the requested information to the plaintiff's employment-related lawsuit against the company did not factor into the Court's analysis in this case.

Under DGCL Section 220, a stockholder may assert its right to inspect the books and records of a company for "any proper purpose." In its recent letter decision in *Mehta v. Kaazing Corp.* (Del. Ch. Sep. 29, 2017), the Delaware Court of Chancery considered one such proper purpose and then proceeded to narrow its application.

To be proper for purposes of satisfying the Section 220 standard, as a basic matter, a stockholder's purpose must be "reasonably related to such person's interest as a stockholder" (quoting *Rock Solid Gelt Ltd v. SmartPill Corp.* (Del Ch. Oct. 10, 2012)) and the stockholder bears the burden of proving such a proper purpose for each item of company information that is requested. The Court clearly affirms that "valuation of one's stock can be a proper purpose for the inspection of books and records" but further refines this standard to require "a particular need or reason for that valuation."

In *Mehta* the Court found, rather summarily, that because the plaintiff had not identified a particular need or reason for the valuation of his membership interests in Kaazing "at this time," he did not have a sufficiently proper purpose for the valuation-related information he sought in his inspection demand, and such demand was denied. Some context for that finding can be gleaned from the cases the Court cites in support, namely *Helmsman Mgmt. Serv., Inc. v. A&S Consultants, Inc.* (Del. Ch. 1987), which states "without a showing of a present need for such a valuation [of stock], a mere statement of that purpose, though valid in law, might not be *bona fide* in fact," while suggesting that a stockholder's need for a valuation of a closely held company in order to make a decision about the sale of its shares might be "*bona fide* in fact."

While subsequent case law will be needed to establish the parameters of what will be considered a valid need or reason for valuation in the context of a stockholder inspection demand, in the meantime the Court has provided a clear defense against any such demand that states no such current, valid need or reason for a valuation.

Plaintiff's Lawyer-Driven DGCL Section 220 Demand Rejected

Vice Chancellor Laster of the Delaware Court of Chancery recently rejected a plaintiff-stockholder's demand to inspect the corporate books and records of A. Schulman, Inc. holding that the stockholder failed to prove a proper purpose under DGCL Section 220. *Wilkinson v. A. Schulman Inc.* (Del. Ch. Nov. 13, 2017). The Court found that the stockholder had "simply lent his name to a lawyer-driven effort by entrepreneurial plaintiffs' counsel."

The Court relied heavily on the specific facts of the case. In particular, Wilkinson stated at his deposition that the reason he sought books and records was that the company had reported negative financial results. But his counsel framed the case around a different issue—as an investigation into possible mismanagement in connection with the board's decision to accelerate the vesting of the former CEO's restricted stock.

The Court considered important Wilkinson's lack of involvement in the case. Wilkinson admitted that he played no role in drafting the categories of documents his counsel sought. He did not review most of the correspondence between his counsel and the company. He took no steps to verify the accuracy of the allegations in the verified complaint that his law firm filed in the case, and he did not participate in drafting responses to the company's interrogatories. The Court also mentioned that Wilkinson has served as a plaintiff for the same law firm in at least seven lawsuits, most of which challenged mergers.

The Court emphasized that it is advisable for stockholders to use counsel in a Section 220 proceeding. But using counsel to carry out the stockholder's wishes is "fundamentally different" from an "entrepreneurial law firm" driving the entire process with "only minor and non-substantive involvement from the ostensible stockholder principal." The company proved in this case that the stockholder's asserted purposes for demanding books and records were not actually his purposes. Rather, they were his counsel's purposes.

Wilkinson is a fact-specific case, but it reminds us that the stockholder has the burden of proving a proper purpose in Section 220 litigation, and the Court will explore evidence that a stated purpose is mere pretext.

"Exemplary Case" for *Corwin/Volcano* Cleansing Results in Delaware Court of Chancery Dismissing Complaint

The Delaware Court of Chancery recently granted a motion to dismiss in what the Court called "an exemplary case of the utility of [the] ratification doctrine, as set forth in *Corwin* and *Volcano*." In *Morrison v. Berry* (Del. Ch. Sep. 28, 2017), Fresh Market's non-controlling founder and director, Ray Berry, spoke with potential equity investors about a private equity takeover without informing the other directors. Berry favored one particular private equity firm and, after he agreed to roll over his equity, that firm made an unsolicited offer. Berry recused himself from consideration of a potential sale, and a special committee of independent directors engaged in a five-month sale process. The private equity firm was the successful bidder, and, on recommendation of the special committee, the board approved the transaction, structured as a tender offer. Nearly 80% of the outstanding shares were tendered, which represented more than a majority of the disinterested shares.

As discussed in the April 2017 issue of *Sidley Perspectives*, *Volcano* extended the stockholder ratification doctrine of *Corwin* to two-step tender offers, stating that "acceptance of a first-step tender offer by fully informed, disinterested, uncoerced stockholders representing a majority of a corporation's outstanding shares in a two-step merger...has the same cleansing effect under *Corwin* as a vote in favor of a merger by a fully informed, disinterested, uncoerced stockholder majority." The plaintiff in *Berry* claimed that due to alleged disclosure violations, the stockholders were not adequately informed and thus did not satisfy the *Corwin/Volcano* test.

According to the plaintiff, the sale process was a "sham" because Berry had already decided to sell to the particular private equity firm and did not disclose the strength of his commitment to that firm to the board, the participants in the auction or the stockholders, and the plaintiff claimed that this had a chilling effect on the sales process. After noting that if Berry had not adequately conveyed his commitment to the board or the participants in the auction, it couldn't have had a chilling effect on their behavior, the Court found that, in fact, the disclosures to stockholders did describe Berry's relationship with the private equity firm. The Court held that the plaintiff failed to plead facts from which it was reasonably conceivable that the tendering of shares was uninformed or coerced, explaining that "whether Berry initially was forthcoming about his relationship with [the firm], I find that his position as of the time of the auction process and go-shop—that is, at the time material to stockholders—was adequately disclosed."

This case demonstrates the burden a plaintiff faces when challenging a board's decision that a merger is in the stockholders' best interest when that merger is then approved by the stockholders themselves. It also addresses a question about the timing of disclosure under *Corwin*. In this case, it was immaterial if, as alleged, Berry had not adequately informed the directors about his commitment to the private equity firm. Rather, because Berry's involvement was disclosed to the stockholders prior to the time they were deciding whether to tender, that decision could not have been uniformed.

New Cornerstone Research Study Highlights M&A Litigation Trends

Cornerstone Research periodically publishes data on M&A litigation trends. Cornerstone generally focuses on federal class action securities filings, including those challenging M&A transactions. Cornerstone's latest report, entitled *Securities Class Action Filings 2017 Q3*, updates Cornerstone's mid-year assessment from August (discussed in the August 2017 issue of *Sidley Perspectives*) and provides data though Q3 2017. Cornerstone co-sponsors the review with Stanford Law School's Securities Class Action Clearinghouse. Cornerstone's Q3 report includes the following key findings:

- ***YTD filings.*** Plaintiffs have filed a record 325 federal class action securities cases during Q1–Q3 2017, of which 153 have been M&A filings and 172 have been non-M&A cases.
- ***Q3 filings.*** In Q3 2017, plaintiffs filed 102 federal class action securities cases—a pace that slowed somewhat from Q1 but remained consistent with Q2. A large percentage (56%) of the Q3 2017 cases were M&A filings. The 57 M&A filings in Q3 were the most of any quarter since the Clearinghouse began tracking M&A filings separately in 2009.
- ***Circuit Court filings.*** Increased M&A filing activity continued in nearly all of the circuits, which is being attributed to the Delaware Court of Chancery's ruling in *Trulia*. Nine of the 11 M&A filings in the Third Circuit were filed in the Delaware District Court, and the Fourth Circuit had the most M&A filings with 13 in Q3 2017 (half of which were against financial firms).

- *Filings by industry.* Filing activity increased in every sector except Energy compared to the 2015–2016 quarterly average, with M&A filings in the Financial sector more than doubling in Q3 2017 compared to the 2015–2016 quarterly average, whereas non-M&A filings decreased. Filings against Biotech, Pharmaceuticals and Healthcare firms, which made up 17 of the 27 filings in the Consumer Non-Cyclical industry, were the second most frequent targets in Q3, although filings against these firms decreased by more than 63% compared to Q1 and 23% for Q2.

CORPORATE GOVERNANCE DEVELOPMENTS

SEC Chair Discusses the SEC's Governance Agenda

In a speech at a Practising Law Institute conference on Securities Regulation in November 2017, SEC Chair Jay Clayton discussed his plans to reduce the number of items on the SEC's near-term (within one year) rulemaking agenda to "increase transparency and accountability." Although reforming the proxy process is not on the near-term agenda, Chair Clayton commented that he believes the SEC should consider reopening the public comment period on the 2010 "Proxy Plumbing" concept release to solicit updated feedback about the proxy system. His particular concerns are that (i) the current proxy process may be "too cumbersome for retail investors" and (ii) the current thresholds for submitting shareholder proposals (or re-submitting repeat proposals) may be too low and adverse to investors' long-term interests.

ISS and Glass Lewis Release Updated Proxy Voting Policies for the 2018 Proxy Season

As described in a recent Sidley Update, Institutional Shareholder Services (ISS) and Glass Lewis & Co. have each released updates to their proxy voting policies for the 2018 proxy season. ISS' policy updates will apply to shareholder meetings held on or after February 1, 2018 and Glass Lewis' policy updates will apply to shareholder meetings held on or after January 1, 2018. The key policy updates relate to the following topics:

- Climate change shareholder proposals;
- Long-term poison pills not approved by shareholders;
- Board gender diversity;
- Board responsiveness (the trigger under the Glass Lewis policy will now be opposition of 20% rather than 25%);
- Proxy access "fix it" shareholder proposals;
- Virtual-only shareholder meetings;
- Dual-class share structures; and
- Compensation-related matters.

The Appendix to that Sidley Update highlights the various circumstances in which ISS and Glass Lewis may recommend votes against one or more directors in an uncontested election. In a previous Sidley Update, we discussed updates ISS recently made to its QualityScore corporate governance ratings tool, including the addition of 11 factors that are newly applicable to U.S. companies.

New SEC Guidance on Shareholder Proposals Calls for Increased Board Involvement

The new guidance suggests that the Division Staff will give some deference to a board's well-informed and well-reasoned analysis of a shareholder proposal.

On November 1, 2017, the Staff of the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14I (CF), which provides new guidance on the excludability of shareholder proposals under Exchange Act Rule 14a-8. The new guidance sets forth a revised framework for analyzing no-action requests under Rule 14a-8(i)(5) (the "economic relevance" exception), which should expand that exclusion's availability. In addition, in no-action requests under Rule 14a-8(i)(5) and Rule 14a-8(i)(7) (the "ordinary business" exception) in which the significance of the proposal to the company's business is at issue, the Division Staff will now expect to see a well-developed discussion of the board's analysis of the proposal and its significance to the company's business. SLB No. 14I suggests that the Division Staff will give some deference to a board's well-informed and well-reasoned analysis. Finally, the new guidance outlines enhanced information requirements for "proposals by proxy" and clarifies when graphs or images may render a proposal excludable. Our Sidley Update, available here, includes a table summarizing the new guidance in SLB No. 14I.

REGULATORY DEVELOPMENTS

SEC Provides Guidance on Regulation G Exemption for Forecasts in M&A Context

In October 2017, the SEC Staff issued a new Compliance & Disclosure Interpretation (CDI) and revised an existing CDI concerning Regulation G. Regulation G generally requires public companies that disclose or use non-GAAP financial measures to reconcile those measures to GAAP. In the new CDI, the SEC Staff makes clear that in the context of a public M&A transaction, Reg G does not apply to financial projections or forecasts that are provided to a financial adviser for the purpose of the adviser rendering a fairness opinion in the transaction, and it does not apply to the summary disclosure accompanying proxy statement or tender offer materials where the adviser provides a summary of the financial analyses underpinning the opinion. A string of state law cases have held that, if a fairness opinion and the summary of the financial adviser's financial analyses accompanying the opinion are based in part on forecasts, then those forecasts are material and must also be disclosed and that the projections should be GAAP-reconciled in order to meet the requirements of Reg G.

Since issuing the CDI, the SEC Staff has participated at various industry conferences where it has discussed the parameters of the CDI so as to address several questions that have arisen post-issuance. It remains to be seen whether the SEC Staff may provide further written guidance on the CDI. The CDI should eliminate certain types of plaintiff stockholder claims that arise in M&A litigation or that may be pending in current litigation. For more information, see our Sidley Update, available here.

CFIUS Reform Legislation Introduced

Inbound investment into the United States, particularly in the technology and infrastructure sectors, may soon face increased regulatory scrutiny. On November 8, 2017, Representative Robert Pittenger (R-NC) and Senate Majority Whip John Cornyn (R-TX), along with several co-sponsors, introduced the Foreign Investment Risk Review Modernization Act. The proposed legislation would dramatically overhaul the scope of authority and procedures of the Committee on Foreign Investment in the United States (CFIUS), the U.S. Government's interagency body that reviews inbound investment for national security-related concerns.

Congress last reformed the CFIUS process in 2007, when it passed the Foreign Investment and National Security Act (FINSA). FINSA revised certain aspects of the process but did not substantially alter the scope of transactions subject to CFIUS review. In recent years, there has been growing concern about foreign investments in sensitive sectors, including in the technology and infrastructure sectors, and in sectors that create cyber vulnerabilities or expose the personal information of U.S. citizens. As discussed in previous issues of *Sidley Perspectives*, over the last year, President Obama and President Trump each formally blocked Chinese investments in the semiconductor sector, and many other transactions have been terminated over CFIUS concerns. However, many observers and government officials believe that the current CFIUS process is outdated and needs to be amended, for example, to allow review of acquisitions of technology that are structured in ways that fall outside the current scope of CFIUS authority.

In introducing the legislation, Representative Pittenger reflected the growing concern about foreign investments in sensitive sectors, stating that Chinese investment may act as a "backdoor effort to compromise U.S. national security." Senator Cornyn suggested that Chinese investment may "exploit gaps in the existing CFIUS review process…effectively degrading our country's military technological edge…"

For an overview of the proposed legislation, see our Sidley Update, available here, which includes a link to our more detailed summary of key aspects of the legislation.

Merger Filers Beware: Department of Justice Challenges a Transaction that Cleared Hart-Scott-Rodino

In September 2017, the Antitrust Division of the U.S. Department of Justice filed a lawsuit seeking to unwind Parker-Hannifin's consummated acquisition of Clarcor. *U.S.A. v. Parker-Hannifin Corp. and Clarcor Inc.* (D. Del. Sep. 26, 2017). In this unusual case, the transaction was filed with the agencies pursuant to the Hart-Scott-Rodino (HSR) Act, but the government took no action during the initial 30-day waiting period, allowing the transaction to close in February 2017. Now, the government alleges the transaction violated Section 7 of the Clayton Act because it was effectively a merger to monopoly in the supply of certain types of aviation fuel filtration systems to U.S. airline and military customers, a line of business worth about $20 million annually.

This suit serves as a reminder that the HSR Act does not "immunize" transactions; nothing in the HSR Act says that clearing the merger review process without government action prohibits a subsequent challenge. Additionally, the size of the market has little effect on the decision to challenge a transaction. In this case, the government concluded that the potential competitive harm is large enough to justify litigation even though the challenged line of business comprises less than 0.5% of the value of the overall transaction ($4.3 billion). Finally, if the competitive overlaps between parties to a transaction are significant but not readily apparent from the content of the HSR filing or a quick review of the parties' public documents, in certain circumstances, it may be advisable to make sure the reviewing agency is aware of the overlap so any concerns can be resolved before closing. Remember, however, that these sorts of challenges are infrequent, highly fact-specific and most likely to arise if the transaction triggers customer complaints, which appears to have been the case here. For more information, see our Sidley Update, available here.

SEC Proposes Amendments to Modernize and Simplify its Disclosure Requirements

In October 2017, the SEC unanimously voted to propose amendments to streamline and improve disclosure requirements applicable to public companies, investment advisers and investment companies. The proposed amendments, as mandated by the FAST Act, are intended to (i) reduce the costs and burdens on registrants while still providing material information to investors, (ii) improve investors' ability to read and navigate public filings and (iii) discourage repetition and disclosure of immaterial information.

Key proposals include:

- ***Streamlining MD&A disclosure.*** Item 303(a) of Regulation S-K would allow registrants to eliminate MD&A discussion of the earliest year when a filing covers three years of financial statements if (i) the discussion is not material to understanding the registrant's financial condition and (ii) the registrant's prior year Form 10-K is filed on EDGAR and includes MD&A of the earliest year of the current filing.
- ***Reducing the need for confidential treatment requests.*** Items 601(a)(5), 601(a)(6), and 601(b)(10)(iv) would allow registrants to omit certain information without submitting a confidential treatment request, including (i) immaterial schedules and attachments from all exhibits, (ii) personally identifiable information and (iii) confidential information in material contracts that is both not material and competitively harmful if disclosed.
- ***Exhibit-related proposals:***
  - Item 601(b)(4)(vi) would require registrants to file an Item 202 description of their Exchange Act registered securities as an exhibit to Form 10-K.
  - Item 601(b)(10) would limit the two-year look back test for filing material contracts to newly-reporting registrants.
  - Item 601(b)(21) would require disclosure of a legal entity identifier (LEI), if a registrant has one, including any subsidiaries required to be listed on the significant subsidiaries exhibit.

For a more detailed summary of these and other proposed amendments, see our Sidley Update, available here.

FCC Order Relaxes Broadcast Ownership Rules

On November 16, 2017, the Federal Communications Commission (FCC) voted 3-2 to adopt an Order significantly relaxing its rules restricting multiple and cross-media ownership. The FCC is statutorily required to review its broadcast radio and television station ownership rules every four years to determine if they are "necessary in the public interest as the result of competition" and to "repeal or modify any regulation [the FCC] determines to be no longer in the public interest." The FCC:

- Repealed its rule prohibiting common ownership of a daily print newspaper and a full-power broadcast station (AM, FM or TV) that serve the same markets.
- Eliminated its rule prohibiting an entity from owning more than two television stations and one radio station in the same market.
- Eliminated the Eight Voices Test that requires eight independent voices to remain in a market where two television stations were proposed to be owned by one entity, and adopted a case-by-case approach to determine whether it would permit two TV stations rated in the top four in the market to combine.
- Eliminated its rule that made joint advertising sales in excess of 15% of a brokered station's broadcast time per week a trigger of ownership attribution.

Because the potential impact of the elimination of these rules is significant, likely permitting more extensive consolidation and future transactions involving media properties, it is highly likely that the Order will be legally challenged before the United States Courts of Appeals. Public interest groups will likely file suit in federal court and seek a stay of the rules pending the outcome of the appeal.

SIDLEY EVENTS

Women in Leadership Trivia Night

January 18, 2018 | Chicago, IL

Team up with (or against!) your friends and colleagues to test your knowledge of pop culture, history, women leaders, music and sports. This interactive, multimedia trivia event is hosted by The Big Quiz Thing. For more information, send an email to chevents@sidley.com.

Annual Sidley Chicago Alumni Celebration

February 15, 2018 | Chicago, IL

This is our third annual Chicago alumni event celebration. We invite all members of the Sidley Chicago Alumni family to join us for a fun evening of celebration and networking with colleagues and peers. This celebration encourages a spirit of community among all of our alumni and current employees. For more information, send an email to chevents@sidley.com.

SIDLEY SPEAKERS

Appraisal Developments

January 12, 2018 | New York, NY

John K. Hughes, a partner in our Washington, D.C. office, will moderate a panel entitled *Appraisal Developments* as part of the Mergers & Acquisitions 2018: Advanced Trends and Developments program hosted by the Practicing Law Institute (PLI) in New York City on January 11-12. Click here for more information.

Recurring Disclosure Challenges / Mergers & Acquisitions

January 23, 2018 | Coronado, CA

The Northwestern Pritzker School of Law is sponsoring the 45th Annual Securities Regulation Institute in Coronado, California on January 22-24. Tom Kim, a partner in our Washington, D.C. office, will chair a session entitled *Recurring Disclosure Challenges* at the conference on January 23. Later that day, Sharon Flanagan, a partner in our San Francisco office, will participate in a panel entitled *Mergers & Acquisitions*. Click here for more information.

SIDLEY RESOURCES

To keep our clients up-to-date on the recent efforts to reform the U.S. tax code, Sidley has launched a *U.S. Tax Reform: Developments and Insights* webpage that features a variety of resources summarizing the major changes with respect to the code generally and relating to particular industries and subject matters. The page also provides convenient access to key government documents related to the tax reform effort, and contacts at Sidley who can provide more information. The latest posting is entitled *Tax Reform: Provisions You May Have Missed and the State of Play* as of December 4.

An article entitled *Hack Attack: Reducing the Risks of Stockholder Litigation Arising from Data Breaches* by Edward McNicholas, Alex Kaplan, James Heyworth and Charlotte Newell, lawyers in Sidley's New York and Washington, D.C. offices, was published in Bloomberg BNA's *Corporate Law & Accountability Report* on November 6. The article discusses how cyberattacks and data breaches can affect your company and recommends steps to take now to help mitigate the risks and consequences of a breach.

An article entitled *Sustainability Disclosures in the EU After the 2014 Non-Financial Reporting Directive* co-authored by Rebecca Grapsas, counsel in Sidley's New York/Sydney offices, was published in the August 2017 issue of *Insights: The Corporate & Securities Law Advisor.*

An article entitled *3 Contract Drafting Myths Debunked* by Robert Velevis, Sara Garcia Duran and Sacha Jamal, lawyers in Sidley's Dallas office, was published by *Law360* on October 30.