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IN THIS ISSUE

ANALYSIS

BOARD EXPOSURE TO CLAIMS OF FAILURE OF OVERSIGHT—COMPLIANCE RISK; BUSINESS RISK; CYBER RISK

By Thomas A. Cole and Alan C. Raul[1]

The exposure of corporate directors to shareholder derivative suits relating to their obligations to provide "risk oversight" to the company may turn in part on whether the obligation is considered to be a "compliance risk" or a "business risk" under Delaware law. Directors are afforded significant discretion under the "business judgment rule" to assess, address and oversee "business risks." A shareholder suit relating to board oversight of a "compliance risk" triggers judicial scrutiny that is somewhat different but also deferential to the board.[2] The critical difference is that directors face virtually no liability for "business risk" oversight if business judgment review is otherwise applicable, whereas directors could face liability for failure to exercise appropriate oversight of "compliance risks" if their failure is shown to be a result of "bad faith" acts or omissions. Even so, the bar to establishing a director's liability for insufficient oversight of "compliance risks" is quite high, given the difficulty of pleading facts that would establish bad faith, and the existence of corporate compliance programs, both of which are factors that have constrained the proliferation of compliance risk suits against corporate boards.

Derivative actions claiming a failure to oversee or monitor compliance risk typically allege that the board ignored "red flags" that, if investigated, would have uncovered the conduct resulting in harm to the company, or that the board's inattention led to a systemic failure to install or monitor the adequacy of information and reporting systems that would assure the board was properly informed of the company's compliance with applicable legal requirements. To state a legally sufficient claim, the plaintiffs must plead that the board violated its fiduciary duty to the company by abdicating its obligation to monitor compliance in either of these respects.

There is no clear overall national trend that descriptively captures shareholder derivative suits regarding board oversight of "compliance risks." There is, however, a noticeable increase in the number of such actions following a cybersecurity incident. In those lawsuits, plaintiffs have sought to characterize board oversight of cybersecurity risks as a new species of "compliance risk" litigation.

In cases where a company's core products and services are regulated, the risks of drawing such lawsuits may be greater than for a less or

1 Thomas A. Cole is a partner in Sidley's Chicago office who served as chair of the firm's Executive Committee for 15 years. Alan C. Raul is the founder and leader of the firm's Privacy, Data Security and Information Law practice. The views expressed in this article are those of the authors and do not necessarily reflect the views of the firm.

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

non-regulated company. For non-regulated entities, the risks associated with a cybersecurity incident are more likely to be characterized as "business risks," but for a highly regulated company, failure to ensure security and integrity of information could credibly be considered a "compliance risk" and actionable if the product of bad faith conduct.

The cases involving regulated entities teach that the company must have a system in place for ensuring compliance with applicable regulatory regimes, and over which the board is able to exercise informed and timely oversight. This responsibility might be delegated, in the first instance, to a board committee such as the Audit or Risk Committee, or some other committee that is dedicated to, and responsible for, the company's compliance with legal and regulatory requirements.

Board Oversight of "Compliance Risks"

- Directors of Delaware corporations may face exposure to derivative suits claiming failure to oversee compliance (and to assure the existence and proper functioning of information systems) before a compliance failure incident has occurred.
  - Shareholder derivative suits brought after such an incident (for example, a monetary settlement entered into by the company to resolve an investigation or other governmental or shareholder inquiry into compliance failures) would typically claim that the board failed to provide sufficient oversight of the risks such compliance oversight failures would pose for the company, either because the company failed to have a system in place or the board ignored "red flags" indicating that the system did not work properly.
- In the criminal context, a board oversight compliance failure can impact a DOJ decision to charge (or not charge) the corporate entity (see U.S. Attorney's Manual 9-28.300 and 9-28.800).
- The touchstone cases are *Caremark* (1996) and *Stone v. Ritter* (2006).
  - In *Caremark*, the plaintiff shareholders claimed that the board had not devoted appropriate attention to the company's compliance with a federal law restricting payments to physicians from drug companies. A settlement between the company and the plaintiffs included assurances the company would implement a more comprehensive compliance oversight system. In reviewing and approving the settlement, the Delaware Court of Chancery explained that directors may face liability for allowing a total failure to implement reporting or information systems or controls, or for consciously failing to monitor such systems or controls, where the directors knew that they were not discharging their fiduciary obligations.
  - In *Stone*, a bank entered into a civil settlement with the government for failure to file reports required by federal law (particularly statutes relating to anti-money laundering, or AML). The plaintiffs later filed a derivative action to recover from the directors the funds that the company had expended in the settlement, based on a claim that the board had not exercised its oversight responsibilities. The record showed that the company had expended considerable resources on an AML compliance program and had procedures in place to regularly monitor compliance. On a motion to dismiss for failure to make a pre-suit demand on the board, the plaintiffs claimed a demand on the board would have been futile because the likelihood of personal liability would have rendered the board incapable of exercising impartial independent judgment in responding to the demand. The court dismissed the case holding that, in light of the preexisting compliance program, the directors' conduct would not likely establish the lack of good faith required to excuse a pre-suit demand on the board. The Delaware Supreme Court affirmed the trial court ruling, and confirmed *Caremark* as the standard that governs director risk oversight claims.

The Delaware Court of Chancery in Caremark: *"It is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."*

- These cases establish the rule that corporate boards must assure themselves "that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself 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." As the Court of Chancery observed in *Caremark*: "It is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."
- Plaintiffs face a high bar to establish director liability: As the Supreme Court held in *Stone* (quoting *Caremark*): "Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation…only a sustained or systematic failure of the Board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." The Supreme Court also observed that director liability based on the duty of oversight "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."
- If a director's liability for failure to oversee compliance risks can be established, damages liability cannot be exculpated under Delaware law, because the violation is considered a failure of the director to act in good faith. That constitutes a breach of the fiduciary duty of loyalty, which cannot be exculpated and therefore subjects the director to personal liability for monetary damages.

Board Oversight of "Business Risks"

- The directors' duty to oversee business risks is governed by the business judgment standard of review, which recognizes that taking prudent and informed business risks (which includes the risk of failure) is a decision inherent in any business enterprise for which the directors should not be held liable.
- Case law, thus far, has distinguished between oversight of <u>compliance</u> risk and <u>business</u> risk, applying the deferential "business judgment rule" to the latter rather than the *Caremark* standard discussed above.
- *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009), which was filed in the aftermath of the 2008 financial crisis, involved allegations that the board of Citigroup violated its fiduciary duty of care by failing to monitor the bank's risk profile, including exposure to subprime loans. The court viewed the claim as a "twist" on *Caremark* style cases, but found that the challenged actions were properly evaluated under the business judgment standard, "even if…framed under a *Caremark* theory."
- The Court of Chancery noted that:
  - "There are significant differences between failing to oversee [in order to limit/prevent] employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk."
  - "While it may be tempting to say that directors have the same duties to monitor and oversee business risk [as with fraud and criminal conduct], imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different." That was because "Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors." In other words, while compliance matters are not something that boards are normally expert in (and therefore, require

The Delaware Court of Chancery in Citigroup: *"To impose oversight liability on directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors."*

compliance systems that should be monitored), the essence of a board's role is to assess and make decisions about business risk. As a consequence, claims that a director breached a duty with respect to such a role would require a more extreme dereliction of duty to be actionable, and far more than simply that the business risk turned out badly.

- Although courts will not hold directors accountable liability-wise for taking a business risk that goes badly, Institutional Shareholder Services (ISS) and institutional investors can impose non-litigation punishment for failure to properly address business risk. A notable example is the reelection campaign targeting the risk committee of the J.P. Morgan board of directors following the London Whale trading loss incident.

Shareholder Derivative Suits Involving Cybersecurity Incidents

- Cyber risk generally appears to fall into the business risk, rather than the compliance risk, category. However, privacy and data security lapses may qualify as compliance issues, at least where there is significant regulation and government oversight associated with major business lines. Failure to comply with various reporting requirements or guidance following data security incidents, may also raise compliance risk oversight issues.
- Shareholder derivative suits have been filed against the boards of several companies in the aftermath of major publicly reported cybersecurity incidents. Some examples include:
  - **Wyndham:** After a series of data breaches, plaintiffs filed claims alleging breach of the fiduciary duties of care and loyalty and waste, for failure to implement adequate data security mechanisms and failure to provide timely disclosure. The case was dismissed with prejudice, because the court found that the board's refusal to prosecute the lawsuit on the corporation's behalf was a good faith exercise of business judgment. In so ruling, the court specifically noted the board's repeated meetings to discuss the cyber incidents, security policies, proposed security enhancements and its hiring of outside consultants. (*Palkon ex rel. Wyndham Worldwide Corp. v. Holmes*, No. 2:14-cv-01234 (D. N.J. 2014)).
  - **Target:** The case is currently pending before the district of Minnesota, and is awaiting the issuance of a report from a special litigation committee of the board. (*Kulla v. Steinhafel*, No. 14-cv-00203 (D. Minn. 2014)).
  - **Home Depot:** A derivative suit was filed in August 2015, asserting that the board's failure to oversee cybersecurity constituted a breach of its fiduciary duties (loyalty, good faith). Described as a "cyber *Caremark*" for attempting to invoke that theory of liability in the cyber context, the suit is ongoing, multiple plaintiffs filed a consolidated complaint in March 2016,[3] and the Home Depot general counsel was voluntarily dismissed as a defendant one month later. (*In re The Home Depot, Inc. S'holder Derivative Litig.*, No. 1:15-cv-2999 (N.D. Ga. 2015), Docket #80 and #81).

Despite the high bar for achieving success in cybersecurity actions, there is a significant risk of potentially high litigation costs, and ISS and institutions imposing non-litigation punishment (e.g., ISS recommendation for stockholders to vote against the entire Target board).

Government and Industry Group Focus on Cybersecurity Issues

Government agencies have issued guidance drawing attention to the importance of the board and senior management in cybersecurity risk management. For example, the National Institute of Standards and Technology's *Framework for Improving Critical Infrastructure Cybersecurity* (Feb. 12, 2014) states: "While they do not replace a risk management process, these five high-level Functions will provide a concise way for senior executives and others to distill the fundamental concepts of cybersecurity risk so that they can assess how identified

3 The plaintiffs also filed suit to compel an inspection of Home Depot's books and records in the Delaware Court of Chancery. Following an answer by the company, the suit was voluntarily dismissed. *Frohman v. The Home Depot, Inc.*, No. 1112-VCMR (Del. Ch. 2016).

SEC Commissioner Aguilar: "Companies need to be prepared to respond within hours, if not minutes, of a cyber-event to detect the cyber-event, analyze the event, prevent further damage from being done, and prepare a response to the event."

Bills recently introduced in the House and Senate would require public companies to disclose whether any of their directors have cyber-expertise.

risks are managed, and how their organization stacks up at a high level against existing cybersecurity standards, guidelines, and practices." In the financial sector, regulators expect (and in some cases require) board approval and oversight of specific cybersecurity plans.[4]

- **Securities and Exchange Commission (SEC):** In a speech on June 10, 2014, SEC Commissioner Aguilar underscored the important role that boards serve with respect to monitoring cybersecurity risk. His comments emphasized the need for companies to:
  - ensure that review of the adequacy of the company's cybersecurity measures is "a critical part of a board of director's responsibilities;"
  - "have appropriate personnel to carry out effective cyber-risk management and to provide regular reports to the board;" and
  - "be prepared to respond within hours, if not minutes, of a cyber-event to detect the cyber-event, analyze the event, prevent further damage from being done, and prepare a response to the event."
- **National Association of Corporate Directors (NACD) Key Principles for Cyber-Risk Oversight:** The NACD has adopted the following principles governing cyber-risk oversight:
  - Directors need to understand and approach cybersecurity as an enterprise-wide risk management issue, not just an IT issue.
  - Directors should understand the legal implications of cyber risks as they relate to their company's specific circumstances.
  - Boards should have adequate access to cybersecurity expertise, and discussions about cyber-risk management should be afforded regular and adequate time on the board meeting agenda.
  - Directors should create and make clear the expectation that management will establish an enterprise-wide cyber-risk management framework with adequate staffing and budget.

Board-management discussion of cyber risk should include identifying which risks to avoid, accept, mitigate, or transfer through insurance, as well as specific plans associated with each approach.

DELAWARE APPRAISAL ARBITRAGE: TWO NEW "PUSHBACKS"?

By Jack B. Jacobs[5]

For over a decade hedge funds have utilized Delaware's appraisal statute as a strategy to arbitrage either the statutory interest rate, or the possibility of a litigated capital gain, or both. Typically, hedge funds will buy into the stock of the target company after a merger is announced, and then litigate or settle the case at a premium above the deal price. Despite the protests of the corporate defense bar, the Delaware courts have held that this practice, whether or not desirable as a policy matter, is not legally prohibited.

Recently, however, two separate developments in Delaware signal a "pushback" designed to discourage this practice. The first development, which is legislative, is intended to reduce the economic incentive to engage in "interest rate arbitrage." The second, which is a recent Delaware Court of Chancery appraisal decision, may have the effect (if not the intent) of reducing the number of appraisal proceedings brought to arbitrage the difference between the merger price and any (expected) higher appraisal award.

4 *See* FFIEC, *Cybersecurity Assessment Tool, "Overview for Chief Executive Officers and Boards of Directors*, available at https://www.ffiec.gov/cyberassessmenttool.htm (last modified Feb. 13, 2016).

5 Jack B. Jacobs is a senior counsel at Sidley who served on the Delaware Supreme Court from 2003 to 2014 and, prior to that, on the Delaware Court of Chancery since 1985. The views expressed in this article are those of the author and do not necessarily reflect the views of the firm.

Amendments to the Delaware Appraisal Statute

Section 262 of the Delaware General Corporation Law (DGCL) confers appraisal rights upon a stockholder of record who (i) holds shares on the date an appraisal demand is made, (ii) continuously holds the shares through the effective date of the merger, (iii) submits a demand for appraisal meeting the requirements of the statute and (iv) has not voted in favor of the merger nor consented to the merger in writing. The Delaware House of Representatives already has, and the Senate soon will, approve amendments to the appraisal statute that would restrict a hedge fund's ability to use appraisal for interest rate arbitrage.

An academic study from April 2016 concludes that the proposed amendments to the DGCL would lead to a significant drop in appraisal cases filed. The authors predict that the proposed de minimis amendment itself would cause appraisal petitions to decline by approximately one-quarter.

The first amendment would eliminate de minimis appraisal cases by limiting the availability of appraisal to cases where a significant dollar amount is at stake. Specifically, it would provide that if the shares eligible for appraisal were listed, pre-merger, on a national securities exchange, the Court of Chancery shall dismiss the appraisal proceeding unless (i) the total number of shares entitled to appraisal exceeds 1% of the outstanding shares of the class or series eligible for appraisal, (ii) the value of the consideration provided in the merger for such total number of shares entitled to appraisal exceeds $1 million or (iii) the merger was approved pursuant to DGCL §253 or §267.

The second amendment would limit the post-merger surviving corporation's exposure to liability for pre-judgment interest by enabling the corporation to voluntarily prepay, to each stockholder seeking appraisal, a cash amount up to the merger price. In that event, interest will cease to accrue upon the amount, and from the time, of the prepayment. This ability to reduce that exposure is significant because, over the past several years, the historically low interest rates have encouraged the filing of appraisals to arbitrage the interest rate differential, separate and apart from the prospect of achieving a litigated capital gain. Under the current appraisal statute, pre-judgment interest runs "from the effective date of the merger through the date of payment of the judgment…compounded quarterly and accru[ing] at 5% over the Federal Reserve discount rate (including any surcharge) as established from time to time during the period between the effective date of the merger and the date of payment of the judgment." As a result, in past years the interest accrued on litigated appraisal awards has constituted a significant portion of the overall final judgment. Permitting voluntary prepayment will reduce the financial incentives for hedge funds to use appraisal for interest rate arbitrage.

The *Dell Inc.* Appraisal Decision Relating to Share Tracing

The second recent development may have the effect of reducing the total number of appraisal arbitrage cases altogether, whether filed for interest and/or capital gain arbitrage reasons. In early May 2016, the Court of Chancery decided *In re Appraisal of Dell Inc.*, C.A. No. 9322-VCL (Del. Ch. May 11, 2016). The Court held that fourteen mutual funds sponsored by T. Rowe Price & Associates, or institutions that relied on T. Rowe to direct the voting of their Dell Inc. shares (the T. Rowe Petitioners), were not statutorily entitled to seek appraisal arising out of the 2013 merger of Dell Inc. into a buyout group comprising affiliates of Michael Dell and Silver Lake Management LLC. All told, over 31.8 million shares beneficially owned by the T. Rowe Petitioners, but held of record by Cede & Co., were statutorily disqualified, because those shares had mistakenly been voted in favor of the merger—unbeknownst to the T. Rowe Petitioners and contrary to their actual voting instructions.

What is startling about this result is that prior Delaware case law, specifically, *In re Appraisal of Transkaryotic Therapies, Inc.* (Del. Ch. May 2, 2007) and its progeny, would have dictated a different outcome. *Transkaryotic* was an appraisal arbitrage case where a hedge fund purchased shares of the to-be-acquired company after the record date in order to seek appraisal for those shares. The surviving corporation moved to dismiss the appraisal claim on the grounds that the hedge fund could not trace its acquired shares to the record owner (Cede & Co.) or prove that those shares were not voted in favor of the merger, as required by the statute. The parties agreed that it was impossible for either side—the investors or the surviving corporation—to show how Cede actually voted those particular shares. The Court declined to impose a share-tracing requirement because doing so would effectively preclude any stockholder that held through Cede from seeking appraisal. Instead the Court held that in those circumstances, it would suffice if the appraisal petitioners can show that the aggregate number of shares held by Cede that were not voted in favor of the merger exceeded the aggregate number of shares for which appraisal was sought. Because those criteria were satisfied in that case, the Transkaryotic Court allowed the appraisal to proceed.

Eight years after *Transkaryotic*, two Court of Chancery decisions adopted that same approach. (*Merion Capital LP v. BMC Software, Inc.* (Jan. 5, 2015) and *In re Appraisal of Ancestry.com, Inc.* (Jan. 5, 2015). That led to an apparent consensus within the corporate law community that it was now settled law that, where the number of shares held by the record holder (Cede) and not voted for the merger exceeds the number of shares for which appraisal is sought, the shares held by an appraisal claimant who held through (and whose stock was voted by) Cede are presumed not to have been voted in favor of the merger.

To the extent there was such a consensus, it was not shared by Dell Inc. and its attorneys, who had developed specific evidence that the shares traceable to the T. Rowe Petitioners had, in fact, been voted in favor of the merger. In these circumstances (Dell Inc. argued), the *Transkaryotic* "no share-tracing" rule did not apply and, as a result, the T. Rowe Petitioners' shares were statutorily disqualified from seeking appraisal. Vice Chancellor Laster credited that argument and distinguished *Transkaryotic* and its progeny. His analysis in the *Dell Inc.* opinion has important implications for the M&A bar.

The Facts

The pivotal fact that drove both the analysis and the result in the *Dell Inc.* appraisal decision was that there was specific reliable evidence that Cede had, in fact, voted the specific shares that were traceable to the T. Rowe Petitioners in favor of the merger. More broadly, the case demonstrated that there is a reliable pathway that enables appraisal petitioners and the surviving corporation to determine, at an early stage, how the omnibus record owner (Cede) voted the specific shares for which appraisal is being sought.

First, the shares beneficially owned by the T. Rowe Petitioners were held by State Street Bank & Trust Company as custodian. For Delaware law purposes, the record holder was Depository Trust Company, which held the shares in the name of its nominee, Cede & Co., which thereby had the legal right to vote the shares and demand appraisal. However, through a daisy chain of authorizations, voting authority for the T. Rowe Petitioners' shares ultimately came to rest with Broadridge Financial Solutions, Inc. The T. Rowe Petitioners *opposed* the merger but, due to a computer system glitch, Broadridge received faulty instructions and submitted proxies voting the T. Rowe Petitioners' shares *in favor* of the merger. The result was to disqualify all those shares from seeking appraisal.

Second, contrary to the evidentiary vacuum that existed in the *Transkaryotic* line of appraisal arbitrage cases, in this case Dell Inc. was able to trace the specific shares owned by the T. Rowe Petitioners and determine how they were voted. By using Broadridge internal control numbers that corresponded to the T. Rowe Petitioners' accounts and related ballot control numbers for each position, Dell Inc. was able to determine that all of the positions in question had been voted for the merger. Based on this factual record, the Court found that "Dell has proven by a preponderance of the evidence that the T. Rowe Petitioners' shares were voted "FOR" the Merger."

The Delaware Court of Chancery in Dell Inc.*: "The evidence showing how Cede voted particular blocks of shares provides a basis for distinguishing the Appraisal Arbitrage Decisions…[If] the corporation demonstrates that Cede actually voted the shares for which the petitioner seeks appraisal in favor of the merger, then…the petitioner cannot…seek appraisal for those shares."*

Prior Case Law

This quite different factual record required the Court to decide whether *Transkaryotic* was still sound Delaware law in a case involving specific proof that the contested shares had been voted in favor of the merger. After re-examining the relevant case law starting from the 1960's, the Court concluded that the prior cases, fairly read, did require an appraisal petitioner to prove that its specific shares seeking appraisal had not been voted in favor of the merger. Against that landscape, *Transkaryotic* and its progeny were outliers which the Court found distinguishable, because all parties in those cases agreed that it was impossible to prove how the specific Cede-held shares had been voted. In *Dell Inc.*, however, that showing could be—and was—made. In the Court's words:

> The evidence showing how Cede voted particular blocks of shares provides a basis for distinguishing the Appraisal Arbitrage Decisions. Under those opinions, an appraisal petitioner that held in street name can establish a *prima facie* case that the…requirement [to prove that the shares were not voted for the merger] was met by showing that there were sufficient shares at Cede that were not voted in favor of the merger to cover the appraisal class…If there is no other evidence, then as in the Appraisal Arbitrage Decisions, the *prima facie* showing is dispositive.
>
> The analysis, however, need not stop there. Once the appraisal petitioner has made out a *prima facie* case, the burden shifts to the corporation to show that Cede actually voted the shares for which the petitioner seeks appraisal in favor of the merger. The corporation can do this by pointing to documents that are publicly available, such as a Form N-PX. Or the corporation can introduce evidence from Broadridge, ISS, and other providers of voting services, such as internal control numbers and voting authentication records. If [that] evidence is not sufficient to demonstrate that Cede actually voted the shares for which the petitioner seeks appraisal in favor of the merger, then the petitioner can continue to maintain the appraisal action. But if the corporation demonstrates that Cede actually voted the shares for which the petitioner seeks appraisal in favor of the merger, then…the petitioner cannot…seek appraisal for those shares.

The Implications

Hedge funds contemplating a purchase of a block of stock in a to-be-acquired company will now face the risk that the post-merger surviving corporation will be able to ascertain whether, in fact, the purchased shares seeking appraisal were voted in favor of the merger and rebut any such presumption. Accordingly, the risk of purchasing shares without knowing in advance whether appraisal will be available for those shares may discourage that appraisal arbitrage strategy.

NEWS[6]

JUDICIAL DEVELOPMENTS

New York's Highest Court Provides a Roadmap for Controller Transactions

In *In the Matter of Kenneth Cole Productions, Inc. Shareholder Litig.*, No. 54 (N.Y. May 5, 2016), the New York Court of Appeals, that state's highest court, ruled for the first time that the deferential business judgment rule may apply to a going-private transaction in which a controlling stockholder purchases the company's outstanding stock held by minority

6 The following Sidley attorneys contributed to the research and writing of the pieces in this section: Suresh T. Advani, Sara B. Brody, Jennifer F. Fitchen, Jenna M. Gallagher, Claire H. Holland, John K. Hughes, Jack B. Jacobs, Kelly L.C. Kriebs, Daniel A. McLaughlin and Andrew W. Stern. We appreciate their contributions.

stockholders.[7] The decision applied to New York corporations the standard announced by the Delaware Supreme Court in *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), under which a board may seek the protection of the business judgment rule if the transaction satisfies six factors: "(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." In order for a plaintiff challenging a transaction to invoke the more exacting entire fairness standard, and thereby survive a motion to dismiss, a complaint must allege facts showing that at least one of these factors was not satisfied. The Court of Appeals in *Kenneth Cole* found that the complaint did not do so, and dismissed the suit.

New York adopted Delaware's approach in finding that, when a controller transaction has been recommended by an independent committee of directors and is subject to the approval of a majority of the minority, or disinterested, stockholders, the directors will be protected by the business judgment rule.

The controlling stockholder in *Kenneth Cole*, who owned 46% of the shares but 89% of the voting stock of the company, proposed a going-private merger at $15 per share, conditioned on approval by a special committee of the board and by a majority of the minority stockholders. Within days of the announcement, a number of stockholder class action lawsuits were filed against the company, the directors and the controlling stockholder alleging breaches of fiduciary duties in connection with the proposed transaction. The special committee spent several months evaluating the proposal and negotiating with the controlling stockholder, ultimately approving a transaction at $15.25 per share. 99.8% of the public stockholders who cast votes then approved the transaction.

On appeal, the Court of Appeals noted the traditional adherence of New York courts to the business judgment rule, but also that freeze-out mergers present potential conflicts that call the business judgment rule's application into question in some cases; thus, only where procedural protections are in place that provide substantial safeguards to minority stockholders will the business judgment rule apply. The Court's holding is particularly significant because the general rule applied by New York courts had been that transactions with controlling stockholders are subject to entire fairness review because the controlling stockholder effectively stands on both sides of the transaction. No New York court had previously squarely addressed whether the business judgment rule could apply if the special committee and majority-of-the-minority vote protections were implemented.

Kenneth Cole provides a roadmap for independent directors who are considering transactions proposed by controlling stockholders of New York corporations. Importantly, the decision should incentivize controllers to condition their offers from the outset on approval by disinterested directors and stockholders. When a process is designed and run in a manner that provides these protections for minority stockholders, the parties to these transactions should be able to reduce the "litigation tax" that has plagued M&A transactions for years. See our Sidley Update on the *Kenneth Cole* decision for more information.

In Delaware, Fully-Informed, Uncoerced Stockholder Vote Leads to Business Judgment Review

In *Singh v. Attenborough*, No. 645, 2015 (Del. May 6, 2016), Delaware's Supreme Court affirmed a Court of Chancery ruling that the business judgment rule is the proper standard of judicial review in post-closing money damages actions where a third-party merger has been approved by a fully-informed, uncoerced majority of the disinterested stockholders.

7 Sidley represented the special committee of independent directors in the transaction and also in the litigation that ended with the decision of the Court of Appeals.

Singh arose from Zale Corporation's sale to Signet Jewelers Ltd. for $21 per share. The plaintiffs claimed that Zale's directors, aided and abetted by Zale's financial advisor, had breached their fiduciary duties. The plaintiffs claimed that, when engaging the advisor, Zale's board failed to sufficiently inquire, and the advisor failed to timely disclose, that one month before being engaged by Zale, the advisor pitched Signet to acquire Zale for between $17-$21 per share. Upon learning of that pitch while the merger proxy statement was being drafted, Zale's board investigated and concluded that the advisor's conduct had not affected the deliberations or price negotiations. Zale disclosed those new facts in the merger proxy statement so that its stockholders had the information pre-vote.

In an initial ruling (*Zale I*), the Court of Chancery reviewed the directors' conduct under *Revlon's* enhanced scrutiny standard, and dismissed the director claims because Zale's charter had an exculpation clause insulating directors from duty of care breaches. The Court did not, however, dismiss the aiding and abetting claim because (i) it found the advisor's disclosure to be untimely; (ii) it was therefore "reasonably conceivable" that the undisclosed potential conflict impeded obtaining a price above $21; and (ii) the conflict might have been purposely concealed.

Since the Corwin *decision in late 2015, approval of a controller transaction by an independent board majority and a fully-informed, uncoerced vote of the disinterested stockholders will cause the standard of review by Delaware courts to shift from enhanced scrutiny under* Revlon *to the more deferential business judgment rule.*

One day after *Zale I* was decided, the Delaware Supreme Court handed down *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015). *Corwin* held that, in post-closing money damages actions where the deal had been approved by an independent board majority and a fully-informed, uncoerced vote of the disinterested stockholders, the applicable standard of judicial review is the more deferential business judgment rule, rather than enhanced scrutiny under *Revlon*.

Zale's financial advisor moved for re-argument in the Court of Chancery on the ground that Corwin required that Court to review the directors' conduct using the business judgment standard. That (the advisor argued) compelled the dismissal of the fiduciary duty claim against the directors, as well as the associated aiding and abetting claim against the advisor. Applying *Corwin*, the Court of Chancery (in *Zale II*) reversed its ruling in *Zale I* and dismissed all claims. The plaintiffs appealed.

In affirming the Court of Chancery's ruling in *Zale II*, the Supreme Court noted the Court of Chancery in *Zale II* had raised the issue of whether, once the business judgment review is triggered by a fully-informed, uncoerced stockholder vote, the plaintiffs seek to rebut the presumption afforded by that deferential standard by asserting that the directors were grossly negligent in discharging their duty of care obligations. The Supreme Court made it clear that that analytical structure was conceptually erroneous because, if validated, it would effectively negate the standard-of-review shift resulting from the informed vote. In such a setting, and barring a showing of waste, the Court noted, dismissal should be the appropriate result.

The Supreme Court also explicitly "distance[d] [itself] from the Court of Chancery's treatment, in *Zale I*, of the claims against the financial advisor." The Supreme Court was "skeptical that the supposed instance of knowing wrongdoing—the late disclosure of a business pitch that was then considered by the board, determined to be immaterial, and fully disclosed in the proxy—produced a rational basis to infer *scienter*." The Court went on to emphasize that "[n]othing in this record comes close to approaching the sort of behavior at issue in" *RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816 (Del. 2015), where *scienter* was found. The Court nevertheless cautioned that "an advisor whose bad-faith actions cause its board clients to breach their situational fiduciary duties (e.g., *Revlon* duties) is liable for aiding and abetting."

Delaware Court of Chancery Thwarts Incumbent Directors' Plan to Reduce Board Size to Avoid a Proxy Contest

On May 19, 2016, Vice Chancellor Laster of the Delaware Court of Chancery granted an injunction blocking the implementation of a board reduction plan that would have precluded the company's stockholders from electing three director candidates at the annual meeting. *Pell v. Kill*, C.A. No. 12251-VCL (Del. Ch. May 19, 2016). The ruling reminds that Delaware courts will carefully scrutinize incumbent board measures designed to influence, or in this case to predetermine, the outcome of a director election.

Cogentix Medical Inc. was formed in March 2015 through a merger of Uroplasty Inc. and Vision-Sciences Inc. (VSI), after which Uroplasty's stockholders held 62.5% of Cogentix's common stock and Robert Kill assumed the same positions at Cogentix that he held at Uroplasty—President, CEO and Chairman. The Cogentix board was classified and consisted of five former Uroplasty directors and three former VSI directors, including Lewis Pell, who owned 7.1% of Cogentix's common stock and was its second largest stockholder.

Animosity between the Uroplasty and VSI directors steadily increased after the merger. In February 2016 Pell announced—in a letter to the board and a public filing—his intentions to change the Cogentix board and management team. If that could not be accomplished by negotiations, Pell would wage a proxy contest at the May 2016 annual meeting to elect himself and two allies to the three Class I board seats up for election. If the proxy contest was successful, the Uroplasty directors could lose majority control of the board.

In response to Pell's proxy contest threat, three of the five Uroplasty directors devised—and the Uroplasty-controlled board approved—a plan to decrease the number of board seats from eight to five and reduce the number of Class I directors to be elected at the annual meeting from three to one. That would enable the Uroplasty directors to forestall the proxy contest and preserve board control. Pell sought a preliminary injunction in the Court of Chancery, claiming that the board reduction plan would deny Cogentix's stockholders their right to vote on his director candidates at the annual meeting. The Court preliminarily enjoined the implementation of the board reduction plan pending a trial on the merits.

Under Delaware law, where directors take action affecting a director election or a vote touching on matters of corporate control, the board must justify its action under a rigorous enhanced scrutiny test. Specifically, the directors must carry the burden of proving that: (i) their motivations were proper and not selfish, (ii) they did not preclude stockholders from exercising their right to vote or coerce them into voting a particular way and (iii) there was a reasonable justification for their actions in relation to a legitimate corporate objective. *Mercier v. Inter-Tel* (Del.), Inc., 929 A.2d 786 (Del. Ch. 2007). Under *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), where the vote involves an election of directors and touches on corporate control, the directors' justification must be not only reasonable but also "compelling," which "requires that the directors establish a closer fit between means and ends."

Chief Justice Leo E. Strine, Jr.: "Directors have no authority to prevent stockholders from seating a new board on the paternalistic grounds that the stockholders did not realize that what was best for them was that the incumbent board remain in power."

In applying this standard to the facts, the Court assumed that the Uroplasty directors' motives were proper and unselfish. The Court also found that it was reasonably probable that the Uroplasty directors would not be able to carry their burden of showing that the board reduction plan was not preclusive, because the plan would preclude the stockholders from electing three directors at the annual meeting thereby establishing a new board majority. The Court also found it reasonably probable that the Uroplasty directors would not be able to show that their actions bore a sufficiently close relationship to a legitimate objective. The factual record demonstrated that the Uroplasty directors approved the board reduction plan to avoid a proxy contest so that they, rather than the Cogentix stockholders, could determine who would serve on the board. As the Court stated: "Unfortunately for the Defendant Directors, the belief that directors know better than stockholders is not a legitimate justification when the question involves who should serve on the board of a Delaware corporation." Lastly, the Court noted that the outcome may have been different had the board determined to reduce the size of the board on a "clear day" rather than in the midst of an anticipated proxy contest.

Delaware Court of Chancery Declines to Intervene When Company Waives Its Delaware Exclusive Forum Bylaw to Settle Litigation in California

In *Niedermayer v. Kriegsman*, C.A. No. 11800-VCMR (Del. Ch. May 2, 2016), Vice Chancellor Montgomery-Reeves of the Delaware Court of Chancery, over plaintiffs' objection, granted a stay of a Delaware proceeding to allow a California court to consider approval of settlement of claims pending in both Delaware and California. This transcript ruling is significant because, although other decisions have addressed and approved forum selection bylaws (see, *e.g., Boilermakers 154 Retirement Fund v. Chevron*, 73 A.3d 934 (Del.Ch. 2013)), Niedermayer is the first time a court has squarely addressed the situation in which a company has waived an exclusive Delaware forum and consented to jurisdiction in another court. Particularly intriguing is the fact that the same defendants had, in an earlier phase of this litigation, successfully enforced the exclusive Delaware forum bylaw in obtaining dismissal of the California proceeding.

Niedermayer *marks the first time a Delaware court has squarely addressed the situation in which a company has waived an exclusive Delaware forum, as often permitted by Delaware exclusive forum bylaws, and consented to jurisdiction in another state's courts.*

CytRx Corp. had adopted a Delaware forum selection bylaw which allowed the company to waive the Delaware forum and consent to an alternative jurisdiction. CytRx's officers and directors were sued in a derivative case in federal court in the Central District of California. The Company also received several books and records demands pursuant to DGCL §220 from stockholders who ultimately filed the Delaware action. The California action was dismissed on forum non conveniens grounds due to the Company's exclusive Delaware forum selection bylaw. The California plaintiffs appealed. During the pendency of the appeal, a settlement was reached with the California plaintiffs and, as part of this settlement, the defendants waived the Delaware forum selection provision and consented to jurisdiction in California. At about the same time, the §220 demand stockholders filed a complaint in Delaware asserting the same claims as in the California action. Defendants moved to stay the Delaware action to allow the California court to move forward with considering whether to approve the settlement. The Delaware plaintiffs opposed the stay and sought an order from the Court of Chancery directing the Central District of California to halt its proceedings to allow the Delaware Court to consider the issue of whether defendants could properly waive the forum selection bylaw. Plaintiffs asserted that permitting the California settlement to proceed would allow defendants to forum shop or run reverse auctions to obtain the most favorable settlement.

Vice Chancellor Montgomery-Reeves declined to intervene in the California proceeding and instead stayed the Delaware case. In reaching this decision, the Court of Chancery found that on the facts of this specific case there was no indicia of gamesmanship. The Delaware plaintiffs had not been diligent in pursuing their case and the California case was not settled in a hurry to undercut the Delaware case; in fact, the California action was settled shortly before the Delaware plaintiffs filed suit. The claims were the same in two actions so there was no argument that one case was stronger than the other. Finally, the Court of Chancery noted that, to the extent the Delaware plaintiffs had objections to the settlement, the California federal court "is qualified to resolve" such objections and found that "practicality and efficiency" favor allowing the California court to consider the settlement.

Delaware Supreme Court Holds That Registration to Do Business in Delaware Does Not Confer General Jurisdiction

Citing a 2014 U.S. Supreme Court case (*Daimler AG v. Bauman*, 134 S. Ct. 746 (2014)) as requiring the reinterpretation of the effect of Delaware's business registration statute, the Delaware Supreme Court recently determined that Delaware's business registration statute is more properly read as "providing a means for service of process and not as conferring general jurisdiction." *Genuine Parts Co. v. Cepec*, No. 528, 2015, 2016 WL 1569077 (Del. Apr. 18, 2016). Chief Justice Strine, writing for the majority, concluded that subjecting a foreign corporation to general jurisdiction in Delaware for claims "having nothing to do with Delaware" is too high a price to pay for the corporation agreeing to be able to do business in Delaware.

Delaware Supreme Court: "In most situations where the foreign corporation does not have its principal place of business in Delaware, that will mean that Delaware cannot exercise general jurisdiction over the foreign corporation."

In line with the other 49 states, Delaware requires any company incorporated outside of Delaware, which wants to legally transact business in Delaware, to file with the Delaware Secretary of State a statement naming the company's registered agent within the state (DGCL §371) and to agree to have the registered agent accept service of process on behalf of the company (DGCL §376). Prior Delaware case law had held that by so agreeing to have the in-state agent accept service of process, the registered foreign company expressly consented to general jurisdiction in Delaware (Sternberg v. O'Neil, 550 A.2d 1105 (Del. 1988)). In *Daimler*, the U.S. Supreme Court held that for general jurisdiction to apply to any particular corporation in any particular state, it must be that the "corporation's affiliations with [such] State are so continuous and systematic as to render [such corporation] essentially at home" in the state. A corporation certainly is "at home" in its state of incorporation and the state of its principal place of business.

In *Genuine Parts*, the court determined that the *Sternberg* interpretation of the Delaware registration statutes as express consent to general jurisdiction would permit an overly broad exercise of jurisdiction that is inconsistent with the *Daimler* ruling. A corporation doing business in many states would have to register to do business in all such states and, if registration was deemed consent to general jurisdiction, the corporation would be subject to general jurisdiction in all such states. However, per *Daimler*, a "corporation that operates in many places can scarcely be deemed at home in all of them." Therefore, mere registration to do business in Delaware will not subject a foreign corporation to general jurisdiction there. However, this is not settled law in all jurisdictions and it is likely that the boundaries of the *Daimler* ruling will continue to be tested.

CORPORATE GOVERNANCE DEVELOPMENTS

Institutional Investors Continue to Increase Their Focus on Long-Tenured Directors

Although gender and racial diversity among newly elected board members is increasing, long director tenures and rising mandatory retirement ages for directors can delay board refreshment and diversification. According to the 2015 Spencer Stuart Board Index, 31% of directors added to S&P 500 boards in 2015 were women—an all-time high—up from 21% in 2010. The number of minority directors appointed to S&P 500 boards also increased over recent years, with 18% of newly appointed directors being minorities in 2015. However, in 2015, female directors represented only 20% of the total directors on S&P 500 boards and minority directors represented only 15%. In an effort to accelerate the process of board diversification, certain institutional investors are using their voting power and influence to encourage companies to focus on board refreshment.

Recent Updates to Governance Principles and Voting Policies

- In April 2016, the NYC Pension Funds substantially revised their Corporate Governance Principles and Proxy Voting Guidelines. As revised, they provide that the funds may vote against governance committee members at a company if there is a lack of adequate board refreshment and succession planning, as evidenced by unusually high average director tenure or an inadequate number of directors recently added to the board.
- The California Public Employees' Retirement System (CalPERS) updated its Global Governance Principles in March 2016, highlighting director tenure as a consideration weighing on director independence. Specifically, the revised guidelines indicate that "director independence can be compromised at 12 years of service." Similar to a "comply or explain" approach adopted in the United Kingdom, the guidelines call for companies to either (i) reclassify a longer tenured director as non-independent or (ii) describe in the proxy statement why the director in question should still be considered independent after 12 years of board service.

Engagement Focused on Director Tenure

- State Street Global Advisors (SSGA) has engaged with hundreds of companies about board refreshment and diversification after adopting guidelines on director tenure in 2014. In its 2015 Year-End Stewardship Report, SSGA announced that it took action against 380 companies and voted against the re-election of 538 directors in 2015 due to tenure concerns.
- BlackRock Inc. revised its proxy voting guidelines in 2015 to specifically permit voting against directors where, among other things, there is "evidence of board entrenchment, insufficient attention to board diversity and/or failure to promote adequate board succession planning over time in line with the company's stated strategic direction." In its Corporate Governance & Responsible Investment Report for the first quarter of 2016, BlackRock highlighted examples of successful engagements relating to board refreshment.
- In April 2016, CtW Investment Group issued a letter to the stockholders of Chipotle Mexican Grill, Inc. urging them to vote against key members of the company's nominating and governance committee. The letter suggested that the company's recent struggles could be attributed at least in part to poor governance, specifically "flawed recruitment processes which have resulted in an entrenched and insular board with a startling lack of racial and gender diversity." As noted in the letter, the median director tenure at Chipotle is "excessively long" (17 years) and its board contains no minority directors and only one female director.

As focus in this area continues to increase, companies should review the composition of their boards and the effectiveness of their board succession plans and be mindful of the governance principles and voting policies of institutional investors who own their stock.

Although we expect the Proposed Regulations to provoke a large number of comments, given the election year and Treasury's stated intention to "move swiftly to finalize them," it is possible that Treasury and the IRS will attempt to finalize the Proposed Regulations before the new administration takes office in early 2017.

TAX DEVELOPMENTS

New Treasury and IRS Regulations Impact Common Intercompany Debt Structures and Limit the U.S. Tax Benefits of Inversions

As part of a broader attack against transactions in which U.S. corporations transform themselves into foreign corporations (inversion transactions), the Treasury Department and the IRS issued proposed regulations on April 4, 2016 that are intended to curtail earnings stripping transactions by way of intra-group debt that generates U.S. interest deductions. In particular, the regulations relate to the classification of purported related-party debt instruments as either debt, equity or partially debt and partially equity for U.S. federal income tax purposes (the Proposed Regulations). The Proposed Regulations target various intercompany financing structures and common tax planning techniques that Treasury and the IRS find objectionable. Although many of these objections relate to inversions, the Proposed Regulations, if finalized in their current form, will also affect a broad range of common tax structures across all industries, including, potentially, structures used by private equity and hedge funds. The Proposed Regulations, if finalized, will generally become effective retroactively for debt issued on or after April 4, 2016. Accordingly, the Proposed Regulations are expected to have an immediate effect on tax planning activities. For more information on the Proposed Regulations and their implications, see our Sidley Update available here.

On the same day, Treasury and the IRS released comprehensive temporary regulations (the 2016 Regulations) that make it more difficult to avoid the application of existing inversion rules and further limit the U.S. tax benefits following an inversion. The 2016 Regulations not only implement the rules announced in Notice 2014-52 (the 2014 Notice) and Notice 2015-79 (the 2015 Notice), but also include additional restrictions on inversion transactions, such as a new rule making it more difficult for serial inverters to avoid the anti-inversion rules. The 2016 Regulations implementing the rules announced in the 2014 Notice and the 2015 Notice are generally effective for acquisitions and post-inversion transactions completed on or after September 22, 2014 and November 19, 2015. The additional restrictions and any changes to the Notices generally apply to acquisitions and post-inversion transactions completed on or after April 4, 2016. For more information on the 2016 Regulations and their implications, see our Sidley Update available here.

SIDLEY SPEAKERS

When the Government Investigates: Strategies to Avoid Turning a Problem into a Travesty/ Hot Topics for Boards in 2016

June 20, 2016 | Stanford, CA

Two Sidley partners will present at The 22nd Annual Stanford Directors' College at Stanford Law School on June 20. Sara Brody will present during a breakout session entitled *When the Government Investigates: Strategies to Avoid Turning a Problem into a Travesty* and Holly Gregory will participate in a plenary session entitled *Hot Topics for Boards in 2016*. Click here for more information.

SIDLEY RESOURCES

On May 17, the SEC's Division of Corporation Finance published new and revised Compliance & Disclosure Interpretations (C&DIs) relating to the use of non-GAAP financial measures as discussed in our Sidley Update entitled *Updated SEC Guidance Will Require Many Public Companies to Revise their Presentation of Non-GAAP Information*. The C&DIs represent a significant change in the Division's approach to non-GAAP financial measures—from a permissive stance to a highly prescriptive one—and identify as problematic several practices that are common in public company earnings releases. Accordingly, in advance of their next quarterly earnings releases, companies should evaluate their use and presentation of non-GAAP financial measures in light of the C&DIs.

On May 11, we published a Sidley Update entitled *Federal Regulators Re-Propose Joint Rule on Incentive-Based Compensation Arrangements at Large Financial Institutions*. A discussed in the Update, six federal financial regulators (including the SEC) are seeking comment on a joint re-proposed rule implementing Section 956 of the Dodd-Frank Act relating to incentive-based compensation arrangements at certain regulated financial institutions. In general, the rule would prohibit covered institutions from awarding incentive-based compensation that is believed to encourage inappropriate risks and would impose mandatory deferral and clawback provisions. It would also require such institutions to disclose certain information regarding the structure of their incentive-based compensation arrangements to the applicable regulator. The rule would apply to any covered institution with average total consolidated assets greater than or equal to $1 billion that offers incentive-based compensation to covered persons, with more rigorous requirements applying to covered institutions with $50 billion or more of average total consolidated assets. Comments on the proposed rule are due by July 22, 2016.

On April 13, the SEC issued a concept release requesting comment on modernizing certain disclosure requirements in Regulation S-K relating to a public company's business and financial information as discussed in our Sidley Update entitled *SEC Issues Concept Release on Business and Financial Disclosure Required by Regulation S-K*. The concept release is part of a comprehensive "Disclosure Effectiveness Initiative" led by the SEC's Division of Corporation Finance to review the effectiveness of public company disclosure requirements and to consider ways to improve them for the benefit of registrants and investors. In particular, the concept release explores the following principal issues: (i) whether Regulation S-K's business and financial information disclosure requirements continue to elicit information that is material to investment and voting decisions; (ii) the costs and benefits of the disclosure requirements to registrants and investors; and (iii) the optimal manner of presenting required disclosures to improve readability and investor access to the information. An Appendix to our Update summarizes the SEC's requests for comment on the Regulation S-K items and additional disclosure-related topics covered in the concept release. The Update also highlights common disclosure deficiencies that the SEC has observed, as noted in the concept release. The comment period will end on July 21, 2016.

An article entitled *Board-Driven Internal Investigations* by Holly Gregory was published in the May 2016 edition of Practical Law's *The Governance Counselor*.