SULLIVAN & CROMWELL LLP

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Recent Trends in Governance Documents

INTRODUCTION

Many boards' nominating and governance committees meet in November and December to consider what changes, if any, to implement in advance of the upcoming proxy season. Among other things, committee chairs may ask management to review the issuer's governance documents with counsel to assess whether any amendments are warranted, particularly in light of recent events, such as the COVID-19 pandemic. Many companies have already revised their governance documents to ensure they are able to operate in a remote world in light of the pandemic, including by adopting emergency bylaws and explicitly allowing for virtual or hybrid shareholder and board meetings.

This memorandum discusses certain recent trends in governance documents. It goes without saying that there is no "one size fits all" model of governance. Amendments to governance documents should not be made in a vacuum; rather, they must be informed by discussions with the board of directors, shareholders and other constituencies and be considered in light of a company's disclosure posture and long-term strategic objectives.

I. THE SHIFT FROM STRUCTURAL DEFENSES TO PROCEDURAL SAFEGUARDS

With the increased focus of large institutional investors, serial shareholder proponents and proxy advisory firms on shareholder rights, many companies have been dismantling structural defenses to takeover and activism tactics by, for example, declassifying boards, adopting proxy access bylaws and allowing (or lowering voting thresholds for) shareholders to take action by written consent or call special meetings of shareholders. At the same time, many companies have been implementing more detailed procedural safeguards in connection with those actions, such as advance notice bylaws.

The changing make-up of governance documents has been driven not only by market forces, but also by Delaware court decisions repeatedly upholding advance notice provisions as "useful in permitting orderly shareholder meetings."[1] The Delaware courts have generally upheld advance notice bylaws as long as they do not "unduly restrict the shareholder franchise"[2] and are not "applied inequitably."[3] The Delaware courts have also taken into account other factors, such as whether the bylaw was adopted in advance of a specific threat. The Delaware courts' permissive view of procedural and informational requirements likely applies to other governance document provisions, such as those governing a shareholder's right to call a special meeting or to act by written consent, subject to the same caveats.

A. ADVANCE NOTICE BYLAWS

Advance notice bylaws are ubiquitous, but companies seeking to refresh their governance documents often seek to implement the latest advance notice "technology." The overarching trend has been to expand the scope of information that needs to be provided for a shareholder proposal or nomination to be deemed "proper" under the company's bylaws. Many modern versions of these bylaws require the proposing shareholder to provide the following (among other) information to the secretary of the company:

- With respect to the proposing shareholder, information relating to the background of the proposing shareholder, its ownership in the company's securities (including any derivative or short interests) and any voting agreements between the proposing shareholder and any other person.
- With respect to any proposed nominee, personal and employment biographical information, completion of a D&O questionnaire, description of any compensation arrangements between the proposing shareholder and the proposed nominee and various undertakings of the proposed nominee (including, in the event that the nominee is elected, to abstain from entering into voting commitments with respect to the nominee's service as a director, adhering to the company's governance and other policies and serving a full term).
- With respect to any shareholder proposal, a description, actual text and rationale of the proposal, the actual text of any rationale that would be disclosed in a securities filing and a description of any material interest of the proposing shareholder in the proposal.

B. SHAREHOLDER REQUESTED SPECIAL MEETINGS

While companies have generally shifted their approach to permit shareholders owning a certain minimum percentage of shares or votes to call special meetings, companies have also incorporated various limitations on this right.

- Many versions of these bylaws require the requesting shareholder to include in its initial notice (i) the specific purpose of such special meeting, (ii) all information required by the advance notice bylaw and (iii) a calculation of the requesting shareholder's holdings (including any derivative or short interests). Bylaws may also require such shareholder to satisfy a minimum holding period requirement (*e.g.*, one year of continuous record ownership prior to the date of the request and/or meeting) and update any information provided to the company as of the record date and/or the date of such meeting (or shortly before the meeting).
- Many versions of these bylaws provide companies with an exemption from holding a shareholder requested special meeting in various circumstances, including (i) if the special meeting request is received by the company during a certain window of time (*e.g.*, during the period that is 90 days prior to the first anniversary of the date of the preceding annual meeting to the annual meeting date); or (ii) the special meeting request relates to an identical or substantially similar item that was presented at a shareholder meeting within a certain period of time of such request (*e.g.*, 12 months prior to such shareholder request) or is otherwise included in a company's notice for a shareholder

meeting that has been called, but not yet held, within a certain period of time of such shareholder request (*e.g.*, 90 days).

- Shareholder proposals requesting companies to lower the holdings threshold required for shareholders to call a special meeting is a notable trend, with companies in the S&P Composite 1500 receiving approximately 32% more of these proposals in 2020 as compared to 2019. Average support for these proposals has remained high, with such proposals receiving, on average, 40% support in 2020.[4] For context, 25% is currently the most common threshold selected by companies in the S&P 500.[5]

C. SHAREHOLDER ACTION BY WRITTEN CONSENT

As with shareholder-requested special meetings, companies have generally shifted towards granting shareholders the right to act by written consent, while instituting procedural safeguards. This trend has been less pronounced than special meeting rights, however, as it is comparatively more difficult to include procedural safeguards around the right to act by written consent. Institutional investors also tend to be less focused on the right to act by written consent if a company has standard shareholder-requested special meeting provisions. For example, certain governance documents require a shareholder seeking to act by written consent to first request that a company set a record date for such purposes and provide in its notice all information required under the advance notice bylaw. Many provisions also require the shareholder seeking to act by written consent to comply with the Securities and Exchange Commission's proxy rules, even if the shareholder intends to solicit consents from fewer than 10 other shareholders. For Delaware companies, it is important to keep in mind that certain restrictions on a shareholder's ability to act by written consent must be included in the corporation's certificate of incorporation, which requires shareholder action to implement (not just unilateral action by the board), while provisions that merely establish processes for ministerial review may be included in the bylaws (which generally can be amended unilaterally by the board).

D. PROXY ACCESS BYLAWS

More than 75% of S&P 500 companies have adopted proxy access bylaws, as compared to 39% five years ago. Given the number of companies that already grant proxy access, the trend has been to amend (or for shareholders to propose that companies amend) such provisions to reflect the latest thinking from shareholder rights proponents. Amendments have focused on, among other matters: (i) whether a proposing shareholder is required to own its shares beyond the annual meeting; (ii) whether shares loaned by the proposing shareholder count as "owned" for calculating the ownership threshold; (iii) the cap on the number of nominees that may be nominated; and (iv) whether nominees who fail to receive sufficient voting support may be re-nominated for election at subsequent meetings.

II. ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) OVERSIGHT

ESG has become an area of heightened focus by companies and their constituencies. Not only is there currently a spirited debate regarding the wisdom of shareholder primacy (*i.e.*, whether shareholder value should be the primary objective or interest underlying director decision-making), companies may also face significant economic and reputational damage as a result of the board's failure to exercise sufficient ESG oversight. Boards also risk shareholder claims that the directors breached their fiduciary duties as a result of a failure to satisfy their duty of oversight. To make such a claim (referred to as a *Caremark* claim), shareholders must allege that a board (i) completely failed to implement any reporting or information system or controls, or (ii) having implemented such a system or controls, consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention.[6] Although *Caremark* claims are among the most difficult claims to plead and prove, recent shareholder claims[7] have survived motions to dismiss, demonstrating that while the burden for surviving a motion to dismiss a *Caremark* claim is high, it is surmountable.

There is a growing trend among public companies to amend their governance documents to explicitly grant ESG oversight responsibilities to a committee of the board and describe the scope of such committee's ESG oversight responsibilities. Alternatively, where companies have chosen to retain ESG oversight as a responsibility of the full board, some companies have chosen to make this responsibility more explicit by adding language about this responsibility to their corporate governance guidelines. While the scope and level of detail varies widely, there are a number of commonalities and topics that are frequently addressed, including:

- ESG oversight generally residing with the full board or being granted to the nominating and governance committees or, if a company has such a committee, the public policy committee.
- Responsibilities include: (i) reviewing and evaluating ESG-related plans and practices; (ii) reviewing current ESG trends and discussing such matters with management and communicating the impact on the company and its stakeholders; (iii) overseeing the development and use of tailored ESG-specific measurement and tracking metrics; (iv) reviewing the company's external ESG-specific communications; and (v) if information is discussed at the committee level in the first instance, reporting out key information to the full board on a regular basis.

III. FEDERAL EXCLUSIVE FORUM PROVISIONS

It is well accepted that exclusive forum provisions requiring that intra-corporate claims be brought in certain specified courts are enforceable in Delaware and many other jurisdictions with respect to state law claims. Until the recent *Salzberg* v. *Sciabacucchi* decision,[8] it was an unsettled question whether exclusive forum provisions were enforceable under Delaware law in relation to federal claims. *Salzberg* validates the ability of a Delaware company to adopt a charter provision directing that all Securities Act of 1933 claims brought by shareholders be filed in federal court.

Adopting such a provision can provide a company with a number of advantages, including the ability to consolidate multijurisdiction litigation, avoid state court forum shopping and parallel filings, take advantage of certain heightened pleading standards and ensure the applicability of the automatic Private Securities Litigation Reform Act (PSLRA) discovery stay.

The decision was also consequential in connection with shareholder litigation relating to public company mergers. Prior to the *In re Trulia* case in 2016,[9] it was common practice for plaintiff lawyers to bring state law fiduciary duty claims (including duty of disclosure) in Delaware Chancery Court in connection with public company mergers. Plaintiff lawyers would typically reach a settlement with the target company pursuant to which the target company would provide "curative" disclosure to shareholders, pay the plaintiff lawyers' attorney fees and obtain a broad release from claims. The *Trulia* court held that it would reject disclosure-only settlements unless the supplemental disclosures were "plainly material" and any releases were narrowly circumscribed. This holding resulted in a spike in federal claims by plaintiff lawyers as they refashioned their fiduciary duty state law claims as federal claims under the federal securities laws. *Salzberg* provides Delaware companies with a basis to consolidate federal claims in respect of public company mergers in Delaware federal court.

While federal forum provisions have been held to be facially valid under Delaware law, uncertainty remains as to whether such provisions will be recognized by non-Delaware courts. For example, in *Handoush* v. *Lease Finance Group*,[10] the California Court of Appeal refused to enforce a forum selection clause on public policy grounds because the selected forum, New York, was likely to uphold a jury trial waiver, and California law does not permit a contractual waiver of the right to a jury trial prior to the occurrence of a dispute.

Further, the *Salzberg* court's analysis was limited to federal forum provisions in a company's charter and not its bylaws, and while it is likely that such a provision in a company's bylaws would be upheld, this was not explicitly addressed by the Court.

IV. ENHANCING BOARD LEADERSHIP AND EVALUATION GUIDELINES

Today, 98.8% of S&P 500 companies have some form of independent leadership (either an independent chair or a lead independent director).

Shareholders, institutional investors and proxy advisors are now calling for enhanced transparency around why a company's independent board leadership structure is appropriate for the company. In response, many companies are providing more detail in their corporate governance guidelines regarding their processes for determining their leadership structures, the roles and responsibilities of their board leader(s) and their board evaluation practices.

The use of corporate governance guidelines generally arose after the New York Stock Exchange adopted a rule in 2003 requiring all listed companies to adopt and disclose corporate governance guidelines that address certain topics, including director qualifications and responsibilities, CEO succession planning and annual board evaluations. Because corporate governance guidelines form a basis for the disclosure included in a company's proxy statement, it is important that these guidelines accurately reflect a company's practices.

For example, in July 2020, shareholders filed complaints against Oracle Corporation, Facebook, Inc. and Qualcomm, Inc. alleging that the directors and officers of these companies breached their fiduciary duties by, among other things, misrepresenting the company's progress towards increasing diversity at all levels of the company. In these complaints, the plaintiffs referred to statements included in corporate governance guidelines, committee charters and proxy statements, which they claim do not accurately represent the companies' practices.

As more companies consider whether to provide enhanced transparency around their leadership structures and evaluation practices in their corporate governance guidelines and other governing documents, it is important to ensure that any disclosures remain consistent not only with the company's other public disclosures, but also with the company's actual practices.

V. SUCCESSION PLANNING PROCESSES BEYOND THE CEO

The pandemic has underscored the importance of robust succession planning, not only for the CEO, but also for the entire senior leadership team. Inadequate succession planning for senior executives can lead to a more prolonged and expensive executive search process and be a factor in stock price headwinds.

In light of these risks, some institutional investors, proxy advisors and other key stakeholders are increasingly calling for companies to publicly disclose a succession planning process for key executives.

In response, some companies are beginning to acknowledge explicitly in their governing documents the importance of both management and board succession planning, such as by including standalone provisions broadly discussing their succession planning processes and/or assigning oversight of these activities to the full board or a committee, as appropriate, in their corporate governance guidelines or committee charters.

Moreover, in light of the continuing push for increased diversity in leadership roles, companies have also begun formalizing their commitment to diversity in their succession planning policies and practices. This change has been driven in part by the NYC Comptroller's Boardroom Accountability Project 3.0, which was launched in October 2019 and calls on companies to adopt "Rooney Rule" policies that require the consideration of both women and racially/ethnically diverse candidates for every open board seat and for CEO appointments. Thus far, 14 of the 17 companies that received Rooney Rule shareholder proposals as part of this initiative have adopted such a policy in their corporate governance guidelines and/or committee charters.

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ENDNOTES

1 *Goggin* v. *Vermillion, Inc.*, C.A. No. 6465-VCN (Del. Ch. June 3, 2011).

2 *Openwave Sys. Inc.* v. *Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228, 239 (Del. Ch. 2007).

3 *Id.*

4 Sullivan & Cromwell LLP 2020 Proxy Season Review: Part 1 (July 15, 2020), *available at* https://www.sullcrom.com/files/upload/SC-Publication-2020-Proxy-Season-Review-Part-1-Rule-14a-8.pdf.

5 Deal Point Data as of September 28, 2020.

6 *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

7 *Hughes* v. *Hu*, No. CV 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020); *In re Clovis Oncology, Inc. Derivative Litig.*, No. CV 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).

8 *Salzberg* v. *Sciabacucchi*, 227 A.3d 102 (Del. 2020).

9 *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884 (Del. Ch. 2016).

10 *Handoush* v. *Lease Finance Group, LLC*, 41 Cal. App. 5th 729 (2019).

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