Corporate Governance Hot Topics

Quarterly Update (July 2020)

Boardroom Buzz

Potential topics for the board's agenda this quarter:

- ➔ How will the board and management tackle strategic planning this Fall in light of COVID-19?
- ➔ Should we make any temporary or permanent changes to our capital allocation framework, our share buy-back policy or our dividend policy in light of COVID-19?
- ➔ Should we make any changes to the frequency or scope of guidance the company provides to the Street in view of COVID-19?
- ➔ Does our succession and business continuity planning adequately take into account the learnings from COVID-19 and other recent events?
- ➔ Does our planning need to adjust for a second wave or unrelated second shock to business continuity?
- ➔ Do we need to revisit our approach to employee compensation and incentives in light of the impact of COVID-19 and other recent events?
- ➔ What is our level of confidence in the effectiveness of our internal controls over financial reporting and disclosure controls and procedures despite the challenges of operating during the pandemic? Do we need to consider enhancements in light of extended remote working conditions?
- ➔ Do we need to strengthen or otherwise update the company's policies, practices and goals with respect to diversity and inclusion?

For more information to help you better understand this evolving business and legal landscape, please see the Sullivan & Cromwell LLP COVID-19 Resource Center, available here.

1. Proxy Advisory and Institutional Investor Updates

- **Proxy Advisors and Institutional Investors Focus on ESG Matters:** On March 9, 2020, ISS published its new specialty U.S. Climate Proxy Voting Guidelines, which is aimed at helping investors integrate climate-related factors into their voting decisions. Key differences in the Climate Policy compared to ISS's General Voting Policy include, among other things, that the Climate Policy generally recommends (i) voting against or withholding votes from directors and relevant committee members for performance failures related to addressing climate-related risks and opportunities (the General Voting Policy does not address climate-related performance issues), (ii) under extraordinary circumstances, voting against or withholding votes from directors, committee members or the entire board due to a series of potential ESG oversight failures, including material failures in guarding against or managing ESG or climate-related risks or a lack of sustainability reporting in the company's public documents (the General Voting Policy does not address ESG oversight failures), and (iii) voting for proposals related to GHG emissions, water issues, renewable energy, product safety and ESG metrics in compensation (all of which the General Voting Policy assesses on a case-by-case basis). ISS's Climate Policy comes at a time when many institutional investors have also publicly stated that they plan to hold boards accountable for ESG failures. For example, State Street's annual CEO letter, which was released on January 28, 2020, announced that, beginning in the 2020 proxy season, State Street will use its recently introduced R-Factor scoring system, which measures how companies are addressing material ESG issues, to inform its voting decisions and will take voting action against directors at large-cap companies that lag behind their peers and do not articulate a plan to improve their score. Similarly, BlackRock's annual CEO letter, released on January 14, 2020, warned that BlackRock "will be increasingly disposed to vote against management and board directors" at companies that do not effectively disclose and manage material ESG risks. ISS's new Climate Voting Policy is available here, and the Sullivan & Cromwell memorandum on this topic, which also includes a side-by-side comparison of the differing provisions between the ISS's Climate Voting Policy and its General Voting Policy, is available here.

- **BlackRock Releases 2020 Investment Stewardship Priorities:** On March 18, 2020, BlackRock released its Engagement Priorities for 2020, detailing its plans for investment stewardship for the year. The five priorities that BlackRock highlighted for its 2020 engagements are board quality, environmental risks and opportunities, corporate strategy and capital allocation, compensation that promotes long-termism, and human capital management, all of which underscore BlackRock's "increased focus on sustainability-related issues and relevant disclosures." Each of these priorities is also accompanied by a high-level "key performance indicator" against which BlackRock will track a company's progress and which will serve as the basis for certain voting decisions. BlackRock is also taking steps to increase transparency in how it conducts investment stewardship, including moving from annual to quarterly voting disclosure, providing prompt disclosure with respect to key votes and enhancing disclosure of its company engagements. The full text of the policy is available here.

- **Glass Lewis Announces Inclusion of Company Opinions in Proxy Research Reports:** On April 2, 2020, Glass Lewis announced it will now include unedited company responses to its research in all of its proxy research reports. Any company that purchases a Glass Lewis report will have the right to submit a Report Feedback Statement at no extra cost, which will be available to investors, unedited, on the front page of each report. This service will also be available to shareholder proponents, dissident shareholders or parties to an M&A transaction that is covered by Glass Lewis's proxy research report for the specific meeting. The full text of the announcement is available here.

2. Corporate Governance, Surveys, Policies and Reports

- **NYC Comptroller Announces Results of Board/CEO Diversity Search Policy Campaign:** On April 14, 2020, the New York City Comptroller and the New York City Retirement System ("NYCRS") announced the results of their Boardroom Accountability initiative, which was launched in October 2019, calling on companies to adopt a board and CEO search policy requiring consideration of women and people of color as candidates for all open positions (often referred to as "Rooney Rule" policies). As part of this initiative, the Comptroller, on behalf of NYCRS, submitted shareholder proposals with 17 companies in the 2020 proxy season requesting that they adopt these policies. Ultimately, the NYCRS agreed to withdraw its proposal at 13 companies (or 76.5%) after those companies agreed to adopt and disclose a board and CEO diversity search policy, but the NYCRS declined to withdraw its proposal at two companies that only adopted Rooney Rule policies that applied to directors, but not to CEO searches, which the NYCRS referred to as merely "half steps." However, one of these two companies sought and received SEC no-action relief on the basis of substantial implementation. Shareholders voted on the NYCRS proposal at the three remaining companies' shareholder meetings, where the proposals failed to pass at two of the meetings and passed at one. Although shareholders and other stakeholders as well as governmental agencies and others continue to push for increased diversity at the board and senior executive levels, there have been some difficulties with getting companies to comply. For example, the California Secretary of State released a March 2020 report detailing the substantial noncompliance with the California board gender diversity legislation that requires public companies with principal executive offices in California to have a specific minimum number of women on their board. The press release announcing the results of the Comptroller's and NYCRS's initiative is available here, and the Sullivan & Cromwell memorandum on this topic is available here.

- **Cornerstone Releases Review of 2019 Accounting Class Action Filings and Settlements:** On April 9, 2020, Cornerstone Research issued a report analyzing accounting class action filings and settlements. According to the report, there were 169 securities class actions involving accounting allegations during 2019 (up 18% from 2018 and nearly double the historical average), driven by increases in both core accounting cases and those related to M&A. Total accounting case settlement value, which can fluctuate substantially from year to year due to the presence or absence of very large settlements, dropped to $920 million in 2019, with the average settlement size also dropping from $111 million to $27 million; however, the median accounting case settlement increased to $10.5 million (up from $9.7 million in 2018). Additionally, the proportion of settled accounting cases involving accompanying SEC actions increased to 44% of all accounting cases—the highest proportion since 1998. The full text of the report is available here.

3. Litigation Developments

- **Delaware Court of Chancery Affirms CEO Termination Decision Protected by Business Judgment Rule:** On April 2, 2020, in *Shabbouei* v. *Potdevin*, the Delaware Court of Chancery granted a motion to dismiss for failure to plead demand futility of a shareholder derivative action against the board of directors of lululemon athletica inc., alleging that the board breached its fiduciary duties by rushing to pay an excessive $5 million severance fee in connection with the former CEO's separation "as a means to cover up their slow response to his well-documented malfeasance." Under *Aronson*, in order to plead demand futility, the plaintiff must plead sufficient facts to support a reasonable inference that either (i) a majority of the board was "interested" in the challenged decision or (ii) the board failed to exercise proper business judgment when making the challenged decision. In rejecting plaintiff's argument that the board was interested in the decision to settle with the CEO because it was trying to cover up its oversight failings (which the Court of Chancery found to be an implied *Caremark* claim), the Court of Chancery stated it was "not conceivable" that the board failed to establish a reporting system, since the company's ethics code and whistleblower hotline were utilized to detect the CEO's misbehavior, and also found that the board's actions in investigating and settling the claim did not implicate a "conscious indifference" to "red flags" underlying such claims. The Court of Chancery also rejected plaintiff's argument that the decision to enter into the separation agreement constituted waste, after finding that the complaint's allegations failed to establish an inference that the board lacked sufficient information when deciding to settle and noting that the decision to settle, which would enable the company to end the CEO's tenure, "swiftly . . . remediate an environment the [c]omplaint describe[d] as 'toxic'" and "avoid potentially costly and embarrassing litigation," all constituted corporate benefits. The full text of the opinion is available here, and the Sullivan & Cromwell memorandum on this topic is available here.

- **Delaware Court of Chancery Bench Ruling Illustrates Fiduciary Duty to Protect from Accumulation Without Paying a Premium:** On November 8, 2019, in a transcript ruling in the ongoing Delaware Court of Chancery case *K-Bar Holdings LLC* v. *Tile Shop Holdings, Inc.*, the Delaware Court of Chancery found that allegations that a board of directors breached its fiduciary duties by failing to take action to prevent an accumulation of control by a stockholder group (which included three of the company's directors) constituted a colorable claim. The plaintiff argued that the board should have adopted a rights plan or obtained a standstill agreement to prevent the insider group from increasing its holdings from 29% to 42%, following a decline in the company's stock price. The Court of Chancery ordered the stockholder group to refrain temporarily from purchasing additional shares and stated that, after an evidentiary hearing, the Court would consider ordering the divestiture of those shares and/or neutering their voting power. The ruling granted in *Tile Shop* illustrates the value of control and the duty of boards to act in the best interest of their stockholders to ensure that a change in control does not occur without existing stockholders receiving a premium. The full transcript of the Court of Chancery's ruling is available here.

- **Delaware Supreme Court Upholds Forum Selection for Securities Act Claims:** In a widely anticipated decision issued March 18, 2020, in *Salzberg* v. *Sciabacucchi*, the Delaware Supreme Court held that Delaware law permits corporations to include in their certificates of incorporation federal forum provisions ("FFPs") that require shareholder actions asserting claims under the federal Securities Act of 1933 to be filed exclusively in a federal court after finding that FFPs are permissible mechanisms for regulating intra-corporate affairs in Delaware charters under DGCL § 102(b) and that FFPs did not violate any positive federal law or public policy. Although the Court found that FFPs are "facially valid" under Delaware law, it also recognized that FFPs may be subject to challenge on an as-applied basis. The *Salzberg* decision provides much-needed guidance regarding the ability of Delaware companies to utilize FFPs in their charters to avoid concurrent state and federal actions asserting the same Securities Act claims, a scenario which companies have faced increasingly since the United States Supreme Court's 2018 decision in *Cyan* barring removal of Securities Act claims filed in state courts. The full text of the decision is available here, and the Sullivan & Cromwell memorandum on this topic is available here.

- **Delaware Court of Chancery Clarifies Fiduciary Duties Under Corporate Opportunity Doctrine:** On January 8, 2020, in *Leased Access Preservation Assoc.* v. *Thomas,* the Delaware Court of Chancery denied a motion to dismiss a claim that a former director usurped a corporate opportunity after successfully outbidding his company, Leased Access Preservation Association ("LAPA"), in order to win a contract to operate a local television station. Though Delaware courts have previously held that the corporate opportunity doctrine does not apply to bidding situations where there is no certainty that the bidding company would win the contract, the Court of Chancery distinguished the facts in *Leased Access* by noting that the director and LAPA were the only two bidders competing for the contract and that LAPA had held the contract for the past five years. As a result, the Court of Chancery found that it was "reasonably conceivable that LAPA had a reasonable expectation in obtaining the contract." Additionally, while the director claimed that he had resigned before placing a competing bid, the Court of Chancery held that the corporate opportunity doctrine could bar a director from pursuing a corporate opportunity even after resigning as a director if he/she began pursuing the transaction or obtained information to aid in pursuing the transaction while still a director.

- **Delaware Court of Chancery Sustains Caremark Claim at the Pleading Stage:** On April 27, 2020, in *Hughes* v. *Hu*, the Delaware Court of Chancery denied a motion to dismiss a *Caremark* duty of oversight claim after finding that the plaintiff adequately pled that the director defendants, who comprised the audit committee of Kandi Technologies Group, Inc., breached their fiduciary duties by failing to oversee the company's financial statements and related party transactions, thereby causing the company to need to restate three years of financial statements. In finding that the complaint's allegations supported a pleading-stage inference that the director defendants "failed to establish a board-level system of oversight for the Company's financial statements and related party transactions, choosing instead to rely blindly on management while devoting patently inadequate time to the necessary tasks," the Court of Chancery noted that, according to the complaint, the audit committee met only when required by securities laws (typically only once per year), devoted inadequate time to its work (never meeting for longer than one hour and "regularly overlook[ing] important issues"), acted mostly through written consent, lacked personnel with sufficient expertise on U.S. GAAP and SEC requirements for equity investments and related-party transactions and had "clear notice" of irregularities and "consciously turned a blind eye to their continuation" (including problems associated with the Company's outside auditor, which had no clients other than the company and was later sanctioned by the Public Company Accounting Oversight Board). This case represents the third time the Court of Chancery has sustained a *Caremark* claim at the pleading stage since its 2019 decision in *Marchand* v. *Barnhill* and reinforces the idea that directors and officers who fail to put in place sufficient board-level systems for oversight and monitoring of key risks may face personal liability for breaches of their fiduciary duties. The full text of the decision is available here.

- **Charges Against Former CEO of Blue Bell Highlight Importance of Transparency and Accuracy in Crisis Communications:** On May 1, 2020, the former CEO of Blue Bell Creameries LP, Paul W. Kruse, was charged with seven felony counts related to his conduct during a 2015 listeria outbreak that led the ice cream manufacturer to recall products and resulted in multiple cases of the illness and three deaths. The charges against Kruse allege that he directed employees to remove Blue Bell products from stores without providing retailers or customers with the reasons for the removal and that he directed Blue Bell to provide vague statements regarding the recall that did not cite concerns over listeria but instead referenced manufacturing irregularities or generic issues related to product quality. The Justice Department also alleges that Kruse rejected a draft press release that included language warning of potential listeria contamination in Blue Bell products and that the culmination of his conduct ultimately resulted in a scheme to defraud customers. The charges against Kruse illustrate the importance of statements made by company leadership during times of crisis, especially when public health is implicated.

4. Disclosure Developments

- **SEC Issues Guidance Regarding COVID-19-Related Disclosures:** On March 25, 2020, the SEC's Division of Corporate Finance issued guidance on how companies should disclose risks and effects related to COVID-19, among other things. The guidance includes questions designed to encourage companies to consider the ways that COVID-19 has or could impact the company's financial condition, capital resources, the value of the company's assets, reporting systems, the implementation of business continuity plans, and/or the demand for the company's products and services. The guidance also recognizes that the impact of COVID-19 may present a number of novel or complex accounting issues and encourages companies to proactively address issues related to financial reporting to ensure that financial reports can be timely made in spite of complications that may increase the length of time that it would otherwise take for a company to prepare such disclosures. Following this guidance, on April 8, 2020, SEC Chairman Jay Clayton and the SEC's Director of the Division of Corporate Finance, William Hinman, issued a public statement encouraging issuers to provide meaningful forward-looking disclosures regarding the impact of COVID-19 in their upcoming earnings releases and on calls with analysts and investors. On June 23, the Division of Corporate Finance issued additional guidance regarding disclosures that companies should consider with respect to business and market disruptions related to COVID-19. Specifically, the new guidance focuses on disclosing the impact of COVID-19 on a company's operations and financial condition, including liquidity and capital resources, and disclosures regarding government assistance and a company's ability to continue as a going concern. The Division of Corporate Finance's March 25th guidance is available here and its June 23rd guidance is available here. The full text of the statement from Chairman Clayton and Director Hinman is available here. The Sullivan & Cromwell memoranda on this topic are available here and here.

- **SEC Proposes Amendments to Regulation S-K:** As part of its ongoing initiative to update and modernize its disclosure requirements, on January 30, 2020, the SEC proposed amendments to Regulation S-K that would eliminate certain requirements in order to reduce duplicative disclosures and focus on material information by, among other things, reducing the number of years of certain financial information that a company is required to provide and revising the MD&A disclosure requirements to require the disclosure of the principal objectives of the MD&A and disclosures related to critical accounting estimates. Other significant proposed changes to MD&A disclosures include moving from a prescriptive to a principles-based approach with respect to the disclosure of off-balance sheet arrangements and providing increased flexibility for the periods to which companies are required to compare the results of their operations, among other things. On the same day, the SEC also issued interpretive guidance outlining certain disclosure considerations when including key performance indicators and metrics in a company's MD&A. In this guidance, the SEC stated that, when using financial and non-financial performance indicators and other metrics to describe a company's business in the MD&A, such disclosure should generally be accompanied by, among other things, a clear definition of the performance indicator or other metric and how it is calculated, as well as explanations of why the performance indicator or metric is useful to investors and how it assists management in managing and monitoring the performance of the company's business. The full text of the proposed amendment is available here, and the SEC's MD&A guidance is available here. The Sullivan & Cromwell memorandum on this topic is available here.

- **SEC Advisory Committee Urges Establishment of ESG Disclosure Policies:** On May 21, 2020, during an open virtual meeting, the SEC's Investor Advisory Committee voted to approve the

Investor-as-Owner Subcommittee's recommendation that the SEC update its reporting requirements to "include material, decision-useful, ESG factors." The report argues that investors require material ESG data to make informed investing decisions and that requiring issuers to provide this information would help remedy the current situation in which ESG data is often inconsistent, unreliable and difficult to compare among companies. While the report does not identify a single ESG disclosure framework to use, it does mention the Global Reporting Initiative, Sustainability Accounting Standards Board and Task Force on Climate-related Financial Disclosures as standards that could "help shape" the SEC's thinking. The report asks the SEC to initiate a series of outreach efforts to investors, issuers and other market participants to help the SEC evaluate potential approaches for updating the current reporting requirements with respect to ESG matters. The full text of the Investor-as-Owner Subcommittee's report is available here. The Sullivan & Cromwell memorandum on the standardization of ESG disclosure is available here.

The entire collection of Sullivan & Cromwell memoranda on corporate governance topics and issues is available here. Sullivan & Cromwell will also be releasing its three-part annual review of the 2020 proxy season during the summer of 2020.

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