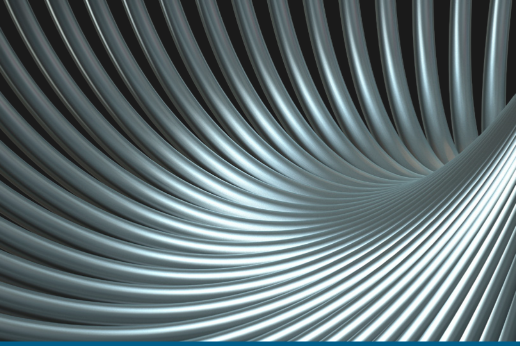

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ANALYSIS

TEN QUESTIONS TO ASK BEFORE JOINING A PUBLIC COMPANY BOARD OF DIRECTORS

By Sara B. Brody and Jason T. Nichol [1]

In an increasingly litigious, regulated and complex public company landscape, director candidates should conduct thoughtful and targeted due diligence on a company and its existing board practices before committing to a role that should be expected to extend over multiple years.

Being asked to join the board of directors of a public corporation is an honor. Board membership can be an enriching experience and an avenue for personal and professional growth. However, in an increasingly litigious, regulated and complex public company landscape, director candidates should conduct thoughtful and targeted due diligence on a company and its existing board practices before committing to a role that should be expected to extend over multiple years. The following are ten questions director candidates should ask themselves and the prospective company. The answers to many of these questions can be found in a company's public disclosures. To demonstrate diligence and an earnestness in learning more about a company, a prospective board candidate may choose to start there before confirming the answers through conversations with current and former directors, senior management or a recruiter.

1. What type of commitment am I making and am I the right fit?

The role of a public company director carries prestige and influence, often affording the director a platform to shape the strategic priorities and direction of some of the country's best and most innovative companies. However, the significant investment of time and energy required for board service, including preparing for, traveling to, and attending board and committee meetings, should be weighed carefully against the director candidate's existing executive and/or board duties (if any) and other personal obligations. Before accepting a director position, a candidate should have frank discussions with current and former board members about the time commitment required for board and committee service, the frequency and nature of meetings (*i.e.*, in-person vs. telephonic or virtual, single day vs. multi-day and any time zone considerations), and when board materials are typically circulated to directors. Strong board and committee meeting attendance is especially important as the proxy rules require disclosure of the name of any director who attends less than 75% of the aggregate meetings of the board and the committee(s) on which the director serves, and proxy advisory firm ISS will generally recommend votes against any director falling below that threshold. A director candidate should also discuss with current or former directors whether they think the board is the "right" size to not only facilitate robust discussion and a diversified approach to decision making but also to equitably distribute work among the board and its various committees.

Additionally, a potential director should reflect on whether the company has a demonstrated need for the director's expertise, how his or her skills and experiences complement those of the other board members, and whether the company's industry, strategic goals, competitive landscape and future opportunities and challenges will enable a potential director to make valuable and lasting contributions to the company. To inform this assessment, the candidate should also inquire as to what committee(s) the candidate would be asked to serve on.

2. What are the internal dynamics of the board and are there any cultural considerations that warrant special attention?

A director candidate should discuss with current and former directors the board's approach to meetings and decision-making, including whether the board and management value difficult or probing questions, whether dissenting voices and opinions are heard, whether

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A director candidate should discuss with current and former directors the board's approach to meetings and decision-making, including whether the board and management value difficult or probing questions, whether dissenting voices and opinions are heard, whether the board strives toward consensus-based decision making, whether there are any specific or recurring areas of disagreement among board members or between the board and senior management and whether the board is interested in taking positions with respect to controversial "issues of the day."

the board strives toward consensus-based decision making, whether there are any specific or recurring areas of disagreement among board members or between the board and senior management and whether the board is interested in taking positions with respect to controversial "issues of the day." Responses to these questions may be substantiated by inquiring as to the board's evaluation processes (*i.e.*, are there any common themes or disparate responses that arise in board evaluations; does the board work regularly with a third-party consultant to improve its internal functioning and governance processes?). To the extent the company's public filings disclose director resignations or unexpected retirements, a candidate should understand the circumstances of the departure, even if no disagreement with management or the board is explicitly disclosed.

A director candidate should also understand any pre-existing or familial relationships between or among directors, significant shareholders, and senior management and, to the extent those relationships exist, whether they are perceived as ultimately beneficial to the company or whether they may inhibit effective governance. To the extent any directors have been appointed or designated by significant shareholders (including activist investors), a candidate should understand the precise nature of such appointment and whether and to what extent such directors are comfortable taking positions that may not fully align with those of the nominating shareholder.

Director candidates should pay particular attention to the board dynamics of a "controlled" public company with one or more controlling shareholders, including whether any specified charter provisions or obligations in a shareholders' agreement may limit the board's authority to take specified actions without the controlling person's consent. In the context of a controlled company, board members may be subject to enhanced judicial scrutiny (often corresponding to increased attention from the plaintiffs' bar) in certain transactions involving a controlling shareholder. Board members of controlled companies should also be cognizant that their board service is effectively at the pleasure of the controlling shareholder.

Finally, a director candidate should consider the perspective of the board and senior management with respect to environmental, social and governance (ESG) matters, including whether significant shareholders or prominent proxy advisory firms have identified actual or perceived deficiencies in the company's ESG efforts or related disclosures.

3. What is the relationship between senior management and the board and what type of information flow does the board receive from senior management?

Director candidates should develop an understanding of the Chief Executive Officer's leadership and working style, including how and to what extent the Chief Executive Officer engages the board in strategy and whether the Chief Executive Officer or other members of senior management regularly seek and take guidance from the board or instead view the board as a group to be "managed." As director candidates will undoubtedly find after joining a board, "tone at the top" permeates managerial culture and will have a meaningful impact on interactions between the board and senior management.

In addition to board books and other formal briefing materials, director candidates should get a sense of informal opportunities to gain information about the company. Are directors invited and encouraged to visit the company facilities and offices? Do directors communicate (even socially) outside of regularly scheduled board and committee meetings? Do directors have meaningful access to senior management, including outside the presence of the Chief Executive Officer?

Finally, director candidates should review the voting results from the company's recent annual shareholder meetings to understand whether any unusual voting results may warrant further explanation. For instance, if tepid "say on pay" voting results suggest shareholder hesitancy or frustration with management's performance, candidates should discuss with members of the board's compensation committee whether any responsive actions from the compensation committee have created points of tension with senior management.

A director candidate should also look out for recent withhold vote campaigns targeting specific directors and understand the basis for any such campaign and whether future campaigns may be on the horizon.

4. How is the company performing operationally and financially and what are the company's most material risks?

In discussions with senior management, a director candidate should inquire as to the nature and engagement of the company's shareholder base, how the company maintains and facilitates shareholder relationships, particularly with marquee investors, and whether any recent fluctuations in share price have generated negative reactions from such investors.

Director candidates should review the company's financial documents and public filings (*e.g.*, the "Risk Factors" and "Management's Discussion and Analysis" sections of its periodic filings and registration statements) as well as analyst reports, news articles and consensus or "Street" estimates. In addition to combing through these filings and publications to better understand the stated risks and opportunities described in the company's own words (and whether those most closely following the company find them persuasive), director candidates should listen to recordings or review transcripts of the company's recent earnings releases to gauge how the company's leadership team interacts with its investor base and see the senior management in action. In discussions with senior management, a director candidate should inquire as to the nature and engagement of the company's shareholder base, how the company maintains and facilitates shareholder relationships, particularly with marquee investors (*i.e.*, is there a dedicated team of investor relations professionals?), and whether any recent fluctuations in share price have generated negative reactions from such investors.

The candidate should understand pending matters likely to materially impact the company's results of operations and financial performance, including material litigation, supply chain and procurement challenges, governmental investigations and human capital initiatives. If a company's financial statements and other filings suggest significant headwinds or a weak financial position, a potential director should expect a greater time commitment for board service, particularly if the director is on a labor-intensive committee such as the audit committee, and increased legal and reputational risks that may arise as a result of the company's financial distress.

A director candidate should also understand how the board approaches its overall responsibility for risk oversight, including whether such oversight is primarily managed by the audit committee, by a separate "risk committee" or addressed by the full board. A director candidate should inquire as to whether the company has identified "mission-critical" regulatory and safety risks over which a board may have a heightened oversight responsibility, a recent focus of Delaware courts.

Finally, a director candidate should understand the board's role in reviewing and addressing whistleblower complaints. Are whistleblower reports regularly provided to the full board or a committee of the board? Does management appear to earnestly investigate whistleblower claims? Does the board have a process to quickly escalate material whistleblower complaints? Have there been any corrective or remedial actions taken recently in connection with a whistleblower complaint?

5. What is management's approach to internal controls compliance and who are the company's auditors?

Potential directors should familiarize themselves with the company's compliance practices, including the company's internal control and financial reporting structures. Even candidates with limited experience in accounting or financial controls (and who may not be tapped for the board's audit committee) should discuss actively with management the internal controls process to ensure that robust reporting policies and procedures appear to be in place. Director candidates should inquire as to whether management has previously identified any significant control failures or material weaknesses in internal controls and, if so, develop an understanding of the resolution and the audit committee's role throughout that process.

Director candidates should also understand the tenure of the company's independent auditors and the relationship between senior management and key personnel at the auditor. If the company has changed auditors in the past three or four years, a director candidate should understand why and review the company's narrative disclosure in its proxy statement to make sure the offered explanation syncs up with the disclosed one.

6. What confidentiality and conflict of interest obligations will apply during and after my board service?

Directors are almost always subject to written confidentiality policies of a company that preclude the disclosure or use of confidential information received in connection with a director's board service. Director candidates should review carefully any confidentiality policies of the company and inquire as to additional confidentiality obligations that may be imposed by state law or otherwise specific to the company's industry, particularly if the director candidate is employed by a company or in an industry with potentially overlapping vendors, suppliers or service providers.

Director candidates should strive to actively identify any actual or potential conflicts of interest that currently exist or may arise during the candidate's term of service and promptly disclose and discuss them with the company's general counsel and board leaders (*e.g.*, the board or audit committee chair or lead independent director). Typical conflicts may include relationships with key vendors, customers or suppliers, material investments in competitors or large shareholders of the company, or financial or other pecuniary interests in potential acquisition targets of the company. Although many conflicts are successfully managed with adequate disclosure, recusal or other proactive measures, actively identifying potential conflicts of interest prior to beginning board service (and promptly raising new issues that arise during a director's tenure) will engender goodwill with the other board members and senior leadership and reduce the risk of duty of loyalty-based litigation. Director candidates should also be mindful of Section 8 of the Clayton Act (15 U.S.C. § 19) which, to address antitrust concerns, generally prohibits the same person from serving as a director of corporations that are competitors.

In addition to clearly understanding confidentiality obligations and actual and potential conflicts of interest, director candidates should also receive a comprehensive briefing from the company's internal counsel regarding compliance with federal and state securities laws (including insider trading laws), the availability and use of Exchange Act Rule 10b5-1 trading plans for directors and any applicable stock ownership guidelines.

7. What sort of protections from legal risks will I be afforded as a director?

As referenced above, director candidates may be named in litigation, particularly in claims arising out of securities offerings or alleging breach of fiduciary duties. Many companies have robust indemnification obligations in their organizational documents that obligate a company to bear a director's legal costs and any settlement or judgment amounts as long as a director has satisfied certain minimum requirements and not engaged in self-dealing or conduct otherwise conflicting with the director's duty of loyalty.

A director candidate should review carefully the company's charter and bylaws to understand the company's indemnification obligations and also request from the company's general counsel any indemnification agreements provided to directors that offer supplemental protections. In particular, a director candidate should understand whether a company's charter exculpates directors for personal monetary liability for breaches of the duty of care (subject to exceptions under applicable state law) and also whether a company is obligated to advance expenses to directors in the event of pending or threatened litigation to avoid a director having to pay out of pocket for legal fees and seek subsequent reimbursement from the company. Director candidates should consider engaging outside counsel to review the company's indemnification obligations and ensure they are both compliant with, and offer the full extent of protection available under, applicable state law.

A director candidate should review carefully the company's charter and bylaws to understand the company's indemnification obligations and also request from the company's general counsel any indemnification agreements provided to directors that offer supplemental protections.

Although indemnification obligations in a company's charter and bylaws should insulate directors from liability in normal circumstances, robust D&O insurance coverage is a critical component of a company's risk management enterprise and should be in place to protect directors in the event of future financial distress or bankruptcy. Potential directors should confer with the company's general counsel or custodian of its insurance program to understand the company's D&O coverage, including the size and layers of the program and the insurers providing coverage. In addition to gaining a general understanding of the company's D&O coverage, a director candidate should understand whether there is an independent directors' liability policy or a "Side A Only" policy (and what those distinctions mean in light of the company's comprehensive insurance portfolio), whether any material claims have been paid under the policy, whether any key insurers have recently changed under the policy, and if the company has a long-standing relationship with its insurance broker. Director candidates should also consider guidance from independent counsel on the adequacy of the company's D&O insurance program and how such coverage intersects with the company's contractual obligations to indemnify directors set forth in the charter and bylaws.

Aside from the financial protections in the charter and bylaws (as may be supplemented by standalone indemnification agreements and D&O coverage), candidates should understand the practical protections, both in terms of personnel and processes, established by the company that will serve as a "first defense" to minimize the risk of reputational harm and financial exposure during a director's service.

8. In addition to the structural director protections against financial exposure described above, what are the practical protections against both financial and reputational exposure I may face as a director?

Aside from the financial protections in the charter and bylaws (as may be supplemented by standalone indemnification agreements and D&O coverage), candidates should understand the practical protections, both in terms of personnel and processes, established by the company that will serve as a "first defense" to minimize the risk of reputational harm and financial exposure during a director's service. In terms of personnel, director candidates should inquire as to the quantity and quality of the company's legal and compliance department(s), the background of the General Counsel or Chief Legal Officer, the strength of the internal auditing team and the experience of the company's investor relations and communications teams.

In terms of processes, in addition to understanding the internal control functions described in Question 5 above, director candidates should also discuss with the company's General Counsel or Chief Legal Officer the company's efforts to comply with applicable law, promote cyber-security (both internally and with respect to third-party service providers), comply with national and international data privacy regulations and, to the extent the company maintains international operations, comply with the Foreign Corrupt Practices Act and other anti-bribery legislation. For companies in heavily regulated industries, a director candidate should understand in general terms the overarching impact of both domestic and international regulations on the company's operations. When discussing these processes with the company's internal legal counsel, a director candidate should also confirm that the company uses qualified outside legal counsel and other consultants and advisors where appropriate to assist in compliance and anticipate legal and regularly risks.

9. What sort of "onboarding" or orientation process is in place?

Following a director candidate's election or appointment, most companies host a formal orientation process to introduce the director to the company, its senior management and directors, operations and competitive landscape, and certain regulatory and industry-specific considerations that may arise during service. Director candidates should inquire as to the nature and scope of the onboarding process, including its duration (some onboarding processes involve two to three days of in-person meetings prior to the outset of board service) and whether the candidate will be responsible for completing any materials that may require advance review by outside counsel or other third parties (*e.g.*, indemnification agreements, stock ownership certifications, conflicts inquiries). Director candidates should understand what members of senior management will participate in the onboarding and, if possible, meet with a wide swath of key personnel, including the heads of the company's investor relations/communications department and compliance and oversight functions and the Corporate Secretary (if different from the General Counsel). Further, candidates should ask whether they will have the opportunity to meet with key external advisors, including the company's external auditors, and whether the company has implemented any ongoing director education initiatives that extend beyond the formal orientation.

10. How will my service as a board member be compensated?

Board member compensation is fully disclosed in a public company's annual proxy statement. That said, director candidates should make sure they understand and appreciate the company's approach to board compensation and perquisites, including the split between cash compensation and equity-based compensation, equity vesting requirements, stock ownership guidelines and any enhancements to compensation for committee chair service. Director candidates may wish to review these compensation and perquisite matters with their personal accounting and legal advisors.

Reflecting on answers to these questions and engaging in thoughtful due diligence will help a candidate evaluate a directorship opportunity and develop a sense of what to expect after board service begins. Careful and thorough due diligence at the outset of a candidacy will pay dividends in determining fit and ultimately positioning a candidate to make a positive and lasting impact on a public company.

REMEDYING DEALS WITH ANTITRUST ISSUES HAS GOTTEN HARDER

By Jim Lowe[2]

In the past year, senior enforcement officials at the DOJ and FTC have strongly objected to behavioral remedies and questioned whether even structural remedies are appropriate when a transaction raises particularly serious antitrust concerns or occurs in an already concentrated market.

Since the implementation in 1978 of the Hart-Scott-Rodino Act (HSR Act), which requires the prior notification of most transactions above a certain size (currently $101 million), parties to transactions that raise serious antitrust issues have often sought to negotiate remedies with the government that would resolve the antitrust issues but also allow the transaction to proceed. In any given year, two dozen or more transactions have been allowed to proceed after the parties entered into consent decrees that allowed the transaction to go forward on the condition that the parties take certain actions or restrict their conduct in a way that the government concluded would resolve its concerns. The remedies the government seeks takes two possible forms: (1) structural relief, which usually requires the sale of the part of one of the businesses in the market that raises antitrust concerns or (2) behavioral (or conduct) relief, which involves the parties agreeing to certain conduct restrictions designed to prevent anticompetitive behavior by the combined company. In the United States there has always been a preference for structural remedies where possible; nonetheless, for many years the government has accepted behavioral remedies where structural remedies were not viable.

In the past decade the U.S. antitrust enforcement agencies — the Antitrust Division of the Department of Justice (DOJ) and the Federal Trade Commission (FTC) — have increasingly and consistently made clear that they will accept behavioral remedies only in rare circumstances, which has limited parties' options for resolving antitrust concerns where structural remedies are not available. And in the past year, senior enforcement officials at both agencies have more strongly objected to behavioral remedies and questioned whether even structural remedies are appropriate when the transaction raises particularly serious concerns or occurs in an already concentrated market. Parties to transactions that raise complex antitrust issues should consider at an early stage the regulatory risks posed by their potential transaction, and each party should try to limit or mitigate its own risk.

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While the agencies do regularly seek to block transactions outright, in the vast majority of cases where the agencies have identified serious competitive concerns, the agencies have been willing to accept remedies in lieu of litigation, allowing the transaction to close and saving limited agency resources.

The History of Antitrust Remedies

Prior to the passage of the HSR Act, most merger enforcement occurred after the affected transaction had already closed. As a result, the government often was forced to seek complex remedies because the merging parties had often already integrated their operations, making it difficult to either force a total unwinding of the transaction or a remedial divestiture. The HSR Act provided the agencies the opportunity to review transactions before they were consummated. This allowed for the agencies to seek remedies — including barring a transaction — prior to closing and thus before any integration and competitive harm occurred. While the agencies do regularly seek to block transactions outright, in the vast majority of cases where the agencies have identified serious competitive concerns, the agencies have been willing to accept remedies in lieu of litigation, allowing the transaction to close and saving limited agency resources.

The type of remedies the government has sought has depended in part of the nature of the transaction. Most transactions that raise antitrust concerns are horizontal, that is, they are transactions between direct competitors, such as a merger of airlines with overlapping routes or a merger between two steel manufacturers. The other type of transaction that has caused the agencies to have serious antitrust concerns are those between parties at different levels of the same supply chain, for example, a merger between a manufacturer and the supplier of a key input for the manufactured good. These types of transactions are called vertical. Horizontal transactions that raise antitrust issues are usually resolved by the divestiture of one of the two overlapping businesses, thus eliminating the parties' competitive overlap.

Vertical transactions raise more complex issues. In a vertical transaction the parties do not compete, so there are not overlapping businesses to divest. In these transactions, the antitrust concern arises because the merger may result in competitive harm in either the market for the input or the market for the manufactured good (or occasionally both). For example, if the input supplier has a very high share of that input, competitors of the manufacturer may have trouble getting the input post-transaction if the merged firm decides to no longer make the input available to the manufacturer's competitors. A divestiture of the input supplier is not a viable option as that is the business the manufacturer is interested in, and any purported efficiencies derived from the transaction result from the integration of the input supplier and the manufacturer.

In the past, the agencies have regularly been willing to at least consider behavioral remedies for many vertical transactions and even some horizontal transactions. For example, a behavioral remedy for the input supplier/manufacturer merger might be a legally enforceable commitment that the combined firm will continue to make the input available to all potential customers on commercially reasonable terms and will put in place firewalls at the input supplier so that it does not provide the manufacturer with information on its competitors. In the case of a horizontal transaction, a behavioral remedy could require the merged firm to make intellectual property available to all customers on fair, reasonable and non-discriminatory terms or could prevent a firm from retaliating against customers who do business with a competitor.

Behavioral remedies became fairly common in a few markets, most notably in the defense industry where there has been significant horizontal and vertical consolidation. Until quite recently, most vertical transactions in that industry that raised antitrust concerns were resolved by behavioral remedies including firewalls, non-discrimination provisions, and/or mandatory licensing.

The Shift Away From Behavioral Remedies

For more than two decades, U.S. antitrust enforcement officials have expressed their preference for structural remedies. The agencies raise three primary concerns with behavioral remedies:

- Behavioral remedies require ongoing monitoring that the agencies, which view themselves as primarily law enforcement rather than regulatory bodies, are not well structured to undertake.
- Violations of behavioral provisions have proven hard to punish and slow to rectify, resulting in competitive harm while the enforcement process is underway.
- It is questionable whether, at least in some cases, the required behavioral remedies prevented the competitive harm identified by the agency at the time of the settlement.

Despite these concerns, the agencies continued to use behavioral remedies on occasion, particularly to resolve competitive issues with vertical transactions. For example, the DOJ required complex behavioral remedies when Comcast acquired NBCUniversal in 2011, and in 2018 the FTC required detailed behavioral commitments in order to clear Northrop Grumman's acquisition of Orbital ATK.

However, not long after the Northrup settlement, the rhetoric regarding behavioral remedies became sharper. In early 2020, Barry Nigro, then the Principal Deputy Assistant Attorney General in the Antitrust Division, noted that the Division vastly preferred structural remedies, even in vertical cases: "[A] competitive market tends not to result from behavioral remedies, which are inherently regulatory, but from structural remedies.... [A] behavioral remedy is inefficient because it mutes the benefits of the free market, in which the competitive process, and not the government, ought to guide the actions of firms.... [A] behavioral remedy substitutes the enforcer's decision making for that of the players."

Shortly thereafter the Division issued a revised Merger Remedies Manual (available here). The Manual states that behavioral remedies "are inappropriate except in very narrow circumstances." Further, "[a] consent decree temporarily regulating conduct, on the other hand, does not effectively redress persistent competitive harm resulting from an indefinite change in market structure. Regulating conduct is inadequate to remedy persistent harm from a loss in competition." The Manual instructs agency staff that "[s]tand-alone conduct relief is appropriate only when the parties prove that: (1) a transaction generates significant efficiencies that cannot be achieved without the merger; (2) a structural remedy is not possible; (3) the conduct remedy will completely cure the anticompetitive harm, and (4) the remedy can be enforced effectively." This is a much higher standard for obtaining behavioral relief than had existed in prior versions of the Manual. The Manual does say that certain forms of behavioral relief may be acceptable but usually only to assist in the success of a divestiture.

More recently, the Division has gone further. In a speech earlier this year, Assistant Attorney General Jonathan Kanter said, "I am concerned that merger remedies short of blocking a transaction too often miss the mark. Complex settlements, whether behavioral or structural, suffer from significant deficiencies. Therefore, in my view, when the division concludes that a merger is likely to lessen competition, in most situations we should seek a simple injunction to block the transaction. It is the surest way to preserve competition." This implies hostility to both behavioral and, in some cases, structural remedies. The Division recently brought its first challenge to a vertical merger in more than four years and in doing so apparently rejected both structural and behavioral remedies offered by the parties.

The FTC has also indicated its increased opposition to behavioral remedies and an increased desire to litigate to block transactions it views as illegal. Its opposition to behavioral remedies is clear in three challenges to vertical mergers it has brought in the past year. In at least two of them the parties offered behavioral remedies that the FTC rejected. In some ways the most surprising was the FTC's challenge to Lockheed Martin's proposed acquisition of Aerojet Rocketdyne. As noted above, competitive concerns in defense industry transactions have often been resolved by behavioral remedies. The presence of the Department of Defense as the primary, if not sole, customer makes remedy enforcement much easier than when there is a plethora of customers and sales channels. And the parties have made clear that they offered remedies similar to those that have been approved in the past. Nonetheless, the FTC brought suit to block the transactions, and the parties then abandoned it.

Implications

Until recently it was often possible for parties to determine, at least within a range, what it would take to resolve competitive concerns arising from a proposed transaction. Both antitrust agencies were regularly willing to settle their concerns through consent decrees. Settlements most often involved divestitures, but on occasion, particularly with vertical transactions, the agencies were willing to accept strict behavioral remedies that were consistent with prior settlements. The agencies usually only took transactions to court when there did not appear to be a feasible remedy short of blocking the transaction (*e.g.*, where the transaction involved the acquisition of a single facility) or where the parties concluded the remedy proposed by the agency was uneconomic or unjustified.

Risk calculation for transactions that raise antitrust issues has become more complex and risk allocation can become a bigger issue than it has been in the past since there may now be a greater risk that the transaction will face litigation and/or will be unable to close for regulatory reasons.

Today parties face antitrust enforcement agencies that are far more skeptical about settlements than in the past and are particularly doubtful that behavioral remedies are ever an acceptable option. Accordingly, risk calculation for transactions that raise antitrust issues has become more complex and risk allocation can become a bigger issue than it has been in the past since there may now be a greater risk that the transaction will face litigation and/or will be unable to close for regulatory reasons. Accordingly, parties should consider the following:

- Determine early in the deal process whether the proposed transaction raises significant antitrust risk and whether there is a meaningful risk of a challenge.
- Analyze whether there could be an economically viable settlement to resolve any antitrust concerns and determine the likelihood that such a settlement would be accepted in the current environment.
- For sellers in an auction process, consider the relative antitrust risk posed by each bidder and consider making acceptance of that risk (including a reverse termination fee for failure to close) a requirement for a successful bidder.
- Particularly for vertical transactions, do *not* assume that behavioral remedies will be accepted in the U.S. even if they would be accepted elsewhere.
- For buyers, carefully consider risk tolerance in the face of seller demands for antitrust risk protections including hell-or-high-water clauses and reverse termination fees.
- Do not assume that antitrust risk can be addressed post-signing; parties that do so often find themselves in litigation against both the government and each other.

PRIVACY AND CYBERSECURITY RISKS IN TRANSACTIONS – IMPACTS FROM ARTIFICIAL INTELLIGENCE AND MACHINE LEARNING, ADDRESSING SECURITY INCIDENTS AND OTHER DILIGENCE CONSIDERATIONS

By Lauren Kitces and Colleen Brown[3]

Cyberattacks. Data breaches. Regulatory investigations. Emerging technology. Privacy rights. Data rights. Compliance challenges. The rapidly evolving privacy and cybersecurity landscape has created a plethora of new considerations and risks for almost every transaction. Companies that engage in corporate transactions and M&A counsel alike should ensure that they are aware of and appropriately manage the impact of privacy and cybersecurity risks on their transactions. To that point, in this article we provide an overview of privacy and cybersecurity diligence, discuss the global spread of privacy and

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cybersecurity requirements, provide insights related to the emerging issues of artificial intelligence and machine learning and discuss the impact of cybersecurity incidents on transactions before, during and after a transaction.

Overview of Privacy and Cybersecurity Diligence

There is a common misunderstanding that privacy matters only for companies that are steeped in personal information and that cybersecurity matters only for companies with a business model grounded in tech or data. While privacy issues may not be the most critical issues facing a company, all companies must address privacy issues because all companies have, at the very least, personal information about employees. And as recent publicized cybersecurity incidents have demonstrated, no company, regardless of industry, is immune from cybersecurity risks.

Privacy and cybersecurity are a Venn diagram of legal concepts: each has its own considerations, and for certain topics they overlap. This construct translates into how privacy and cybersecurity need to be addressed in M&A: each stands alone, and they often intermingle. Accordingly, they must both be addressed and considered together.

Privacy requirements in the U.S. are a patchwork of federal and state laws, with several comprehensive privacy laws now in effect or soon to be in effect at the state level. Notably, while it doesn't presently apply in full to personnel and business-to-business personal data, the California Consumer Privacy Act covers all residents of the state of California, not just consumers (despite confusingly calling residents "consumers" in the law). Further, there are specific laws, such as the Illinois Biometric Information Privacy Act and the Telephone Consumer Protection Act, that add further, more specific privacy considerations for certain business activities. And while there is an assortment of laws with a wide variety of enforcement mechanisms from private rights of action to regulatory civil penalties or even disgorgement of IP, one consistent trend is the increasing potential for financial liability that can befall a non-compliant entity.

Laws in the U.S. related to cybersecurity compliance are not as common as laws related to responding to and notifying of a data breach. In recent years, specific laws and regulations have largely focused on the healthcare and financial services industries. However, legislative and regulatory activity is expanding in this space, requiring increasingly specific technological, administrative and governance safeguards for cybersecurity programs well beyond these two industries. Additionally, while breach response and notification where sensitive personal data is impacted has been a well-established legal requirement for several years now, increasingly complex cyber-attacks on private and public entities has expanded the focus of cybersecurity incident reporting requirements and enterprise cybersecurity risk considerations.

What Does This All Mean for Diligence?

For the buy side, identifying the specifics of what data, data uses and applicable laws are relevant to the target company is pivotal to appropriately understanding the array of risks that may be present in the transaction. Equally, at least basic technological cybersecurity diligence is important to understand the risks of the transaction and potential future integration. For the sell side, entities should be prepared to address their data, data uses and privacy and cybersecurity obligations in diligence requests.

Separately, privacy and cybersecurity diligence should not focus solely on the risks created by past business activity but also consider future intentions for the data, systems and company's business model. If an entity is looking to make an acquisition because it will be able to capitalize on the data that the acquired entity has, then diligence should ensure that those intended uses won't be legally or contractually problematic. This issue is best known earlier than later in the transaction, as it may impact the value of the target or even the desire to move ahead.

In the event that diligence uncovers concerns, some privacy and cybersecurity risks will warrant closing conditions and/or special indemnities to meet the risk tolerance of the acquiring entity. In intense situations, such as where a data breach happens or is identified during a transaction, there may even be a price renegotiation. Understanding the depth and presence of these risks should be front of mind for any entity considering a sale to allow for timely identification and remediation and in some instances to understand how persistent risks may impact the transaction if it moves ahead. For all of these situations, privacy and cybersecurity specialists are critical to the process.

The Global Spread of Privacy Requirements

The prevalence of global business, even for small entities that may have overseas vendors or IT support, creates additional layers of considerations for privacy and cybersecurity diligence.

Privacy and cybersecurity laws have existed in certain jurisdictions for years or even decades. In others, the expanded creation of, access to and use of digital data, along with exemplars like the European Union (EU) General Data Protection Regulation, have caused a profound uptick in comprehensive privacy and cybersecurity laws. Depending on how you count, there are close to or over 100 countries with such laws currently or soon to be in place. This proliferation and dispersion of legal requirements means a compounding of risk considerations for diligence.

It is critical to ensure that the appropriate team is in place to diligence privacy and cybersecurity for global entities and to help companies take appropriate risk-based approaches to understanding the global compliance posture.

Common themes in recently enacted and proposed global privacy and cybersecurity laws include data localization, appointed company representatives, restrictions on use and retention, enumerated rights for individuals and significant penalties. Moreover, aside from comprehensive laws that address privacy and cybersecurity, other laws are emerging that are topic-specific. For example, the EU has a rather complex proposed law related to the use of artificial intelligence. It is critical to ensure that the appropriate team is in place to diligence privacy and cybersecurity for global entities and to help companies take appropriate risk-based approaches to understanding the global compliance posture. It can be difficult to strike a balance in diligence priorities due to both the growing number of new global laws and the lack of many (or any) historical examples of enforcement for these jurisdictions. But robust fact-finding paired with continued discussions on risk tolerance and business objectives, and careful consideration of commercial terms, will help.

Artificial Intelligence and Machine Learning

As mentioned, artificial intelligence is a hot topic for privacy and cybersecurity laws. One of the biggest diligence risks related to artificial intelligence and machine learning (AI/ML) is not identifying that it's being used. AI/ML is a technically advanced concept, but its use is far more prevalent than may be immediately understood when looking at the nature of an entity. Anything from assessing weather impacts on crop production to determining who is approved for certain medical benefits can involve AI/ML. The unlimited potential for AI/ML application creates a variety of diligence considerations.

Where AI/ML is trained or used on personal data, there can be significant legal risks. The origin of training data needs to be understood, and diligence should ensure that the legal support for using that data is sound. In fact, the legal ability to use all involved data should be assessed. Companies commonly treat all data as traditional proprietary information. But privacy laws complicate the traditional property-law concepts, and even if laws permit the use of data, contracts may prohibit it. Recent legal actions have shown the magnitude of penalties a company can face for wrongly using data when developing AI/ML. Notably, in 2021 the FTC determined that a company had wrongly used photos and videos for training facial recognition AI. As part of the settlement, the U.S. Federal Trade Commission ordered that all models and algorithms developed with the use of the photos and videos be deleted. If a company's primary offering is an AI/ML tool, such an order could have a material impact on the company.

Additionally, the use of AI/ML may not result in the intended output. Despite efforts to use properly sourced data and avoid negative outcomes, studies have shown that bias or other integrity issues can arise from AI/ML. This is not to say the technology cannot be accurate, but it does demonstrate that when performing diligence it is crucial to understand the risks that may be present for the purposes and uses of AI/ML.

Security Incidents

Security incidents have been the topic of many a headline over the past few years. Some of these incidents are the result of the growing trend of ransomware or other cyber extortions, including data theft extortions or even denial-of-service extortion. The identification of a data security may well have a serious impact on a transaction. Moreover, transactions can be impacted by data security incidents occurring before, during and after a transaction. Below we outline some key considerations for each.

Depending on the nature of the deal, a special indemnity relative to an identified cyber incident that occurred prior to the transaction may be advisable, and it is important to gather as much information about the incident as possible so as to accurately project the potential liabilities arising from residual risks and negotiate a special indemnity.

An Incident Happened BEFORE a Transaction Started

- Incidents that happened before a transaction will generally only be known if the company identified them, so it is key to employ a detailed and thought-out list of diligence questions.
- Be certain that you have experts involved who themselves understand the impact of the information being provided and have up-to-date knowledge of current cyber events.
- It is imperative not to consider these issues in a silo. Incidents may result in litigation, insurance ramifications and reporting requirements with a variety of regulators. Ensure that privacy and cybersecurity diligence is coordinated with other specialists to avoid gaps or missed information-sharing opportunities.
- Be sure to assess the likelihood that a past incident could create future liabilities. For example, when reporting an incident to the Office for Civil Rights at the Department of Health and Human Services, it is not uncommon for several years to pass before there is an investigation.
- Equally important is ensuring that the company actually completed appropriate remediation.
- If an incident has been identified, accounting for residual risk should be part of the agreement. Representations that there have been no incidents (partnered with any appropriate disclosures otherwise) are standard even where no incident has been identified. However, known incidents are unlikely to be covered by representations and warranties insurance, and therefore more specific options may be prudent. For example, depending on the nature of the deal, a special indemnity relative to such an incident may be a good idea, and it is important to gather as much information about the incident as possible to accurately project the potential liabilities arising from residual risks and negotiate a special indemnity.

An Incident Happens DURING a Transaction

- An incident that starts or is identified as ongoing prior to signing may cause a transaction to pause or be renegotiated. Always maintain open and immediate communication with the transaction leads when an incident is identified—or suspected.
- An incident that happens or is identified as ongoing between signing and close can create a series of complex issues. Potentially the most problematic is that it can take a while to understand the full nature and impact of an incident. This may make it challenging to argue that an incident meets certain standards (*e.g.*, a material adverse event) that could allow the parties to walk away within the necessary contractual time period. In such incidents, it is imperative that appropriate legal, regulatory and technical talent is leveraged to investigate and determine the facts as soon as possible.
- If moving ahead with the transaction, it is imperative to assess the new risks being assumed. This includes preparing for immediate post-close response and remediation actions.

- While it can be a challenge, before the consummation of a deal it is critical to watch the lines of separation to preserve the breached entities' privilege needs and independent responsibility with respect to the incident.

An Incident Happens AFTER a Transaction

- Incidents post-close are likely to be the responsibility of an acquiring/merging entity.
- However, it's key to understand when the incident began as that may impact options, responsibilities, liabilities and indemnification rights (particularly if it actually started pre-close).
- Be sure to also verify what, if any, specific protections were included in the agreement that may relate to an incident.

While far from the totality of privacy and cybersecurity considerations for transactions, these topics should help establish a baseline understanding of what to look for and how to approach privacy and cybersecurity in the current legal environment.

NEWS[4]

JUDICIAL DEVELOPMENTS

Corwin Cleanse Clarified: Key Lessons for Interested Directors

Since *Corwin v. KKR Financial Holdings LLC*, Delaware courts have adhered to the proposition that "when a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies." However, the Delaware Court of Chancery recently issued an opinion clarifying the application of *Corwin* to the fiduciary duties of interested directors. *Lockton et al. v. Rogers et al.* (Del. Ch. Mar 1, 2022). The Court declined to dismiss a complaint alleging that the defendant directors' approval of a merger was a breach of the directors' duty of loyalty and constituted unjust enrichment. Specifically, the Court rejected the defendant directors' contention that *Corwin* "cleansed" the transaction and, as a consequence, explained that a duty of loyalty analysis was still appropriate.

In May 2020, WinView, Inc. merged with a wholly-owned subsidiary of a Canadian company to create a new entity, Engine Media Holdings, Inc. Following the consummation of the merger, several stockholders sued, claiming that the named WinView directors breached their fiduciary duties to the company and its stockholders and were unjustly enriched as a result.

Prior to the merger, several directors had received incentive awards and securities in connection with a series of debt and equity financings. The progression of these financings resulted in the named directors being both secured creditors and preferred stockholders. This created a potential conflict of interest, as the contemplated merger treated WinView's common stockholders differently from secured creditors and preferred stockholders.

The merger agreement eliminated WinView's common stock. Instead, the contemplated capital structure tied common stockholders' compensation to the success of patent lawsuits and afforded the new entity, Engine Media, the authority to take "reasonable efforts" to monetize the company's existing patent portfolio. As a result, one stockholder plaintiff sent a letter to the board opining that the company's own pursuit of patent litigation was a better alternative to consummating the merger. The letter also highlighted the director defendants' conflicts of interest as dual stakeholders, noting that the director defendants had threatened to foreclose on the company's patents as secured creditors to gain leverage.

4 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Sonia Gupta Barros, Julia L. Bensur, Samuel B. Boxerman, Evan Grosch, James Heyworth, Claire H. Holland, Sasha Hondagneu-Messner, Alex J. Kaplan, David Moon, Charlotte K. Newell, Natalie A. Piazza, Andrew K. Stern, Robert S. Velevis and Leonard Wood. Some of the pieces first appeared in Sidley's Enhanced Scrutiny blog, which provides timely updates and thoughtful analysis on M&A and corporate governance matters from the Delaware courts and, on occasion, from other jurisdictions.

The plaintiffs' complaint alleged that one of the named directors had interfered with attempts to secure financing to pursue patent litigation, as had been previously suggested.

On March 11, 2020, the merger was approved by WinView's board of directors without having commissioned a fairness opinion or retained outside advisors to evaluate the treatment of various classes of stock under different options. As both secured creditors and preferred stockholders, the named directors received $13.8 million (of WinView's $35 million valuation) in stock.

In their defense, the named directors relied on *Corwin*, asking the Delaware Court of Chancery to dismiss the complaint because the merger had been "approved by a fully informed, uncoerced vote of the disinterested stockholders" and thus claiming that the business judgment rule shielded them from any fiduciary liability. The Court explained that the rationale underlying the business judgment rule, and *Corwin*, is that "the Court should acquiesce to a judgment expressed by a majority of unconflicted stockholders." However, the Court clarified that the vote of a majority of stockholders may be effective to approve the merger in such cases but that review of the merger "under traditional principals [sic] of fiduciary duty" shall nevertheless proceed. Having found that the stockholder plaintiffs had adequately pled claims of breach of fiduciary duty and unjust enrichment, the Court denied the director defendants' motion to dismiss in relevant part.

The Delaware Court of Chancery's reaction to the named defendants' arguments offers valuable insights into the treatment of fiduciary duty claims involving interested directors.

- **Excluding an interested director from the vote may not be enough if the director negotiated the transaction.** The board of directors had formed a special committee to negotiate the merger and excluded one interested director from the committee. Despite this, however, the plaintiffs alleged that the excluded director had personally negotiated a binding term sheet for the merger. The Court explained that "Delaware law does not allow directors who negotiated a transaction to specifically shield themselves from any exposure to liability by deliberately absenting themselves from the directors' meeting at which the proposal is to be voted on."
- **Potential conflicts may exist when directors are also creditors.** As in this case, special issues arise when directors are also creditors, but the duty of loyalty "does not require self-sacrifice." The Delaware Court of Chancery's opinion suggested that a key consideration is whether a director's actions go beyond the mere exercise of her rights as a creditor and extend into "unfairness" territory. While this suggests that a director's dual position as stockholder and creditor is not fatal, an enhanced financial stake could be looked at with heightened scrutiny.

New School SPAC Subject to Old School Rules: Delaware Court of Chancery Rejects SPAC Sponsor's Motion to Dismiss

Sidley previously covered the MultiPlan Corp. special purpose acquisition company (SPAC) litigation relating to the de-SPAC merger of Churchill Capital Corp. III and its target, MultiPlan Corp. In January 2022, the Delaware Court of Chancery issued its long-anticipated decision on the defendants' motion to dismiss—the first dispositive motion to be briefed and decided in the Delaware courts in the wave of recent SPAC litigation.

The *MultiPlan* complaint alleged that Michael Klein, Churchill's controlling stockholder, received "founder" shares constituting 20% of the SPAC equity, which he purchased for a nominal price. Klein's founder shares would convert into common shares upon completion of a de-SPAC transaction, but if no transaction materialized, the SPAC would liquidate, leaving the founder shares without value. The complaint also alleged that members of Churchill's board of directors, including Klein's brother and a close business associate, were handpicked by Klein and received economic interests in the founder shares without diluting Klein's control of Churchill. Churchill also hired The Klein Group LLC (where Klein is the managing member/majority partner) as a financial advisor in connection with the merger; the Klein Group was paid $30.5 million for its services. Finally, the complaint alleged that the board failed to perform adequate diligence in proposing MultiPlan as the de-SPAC target company and that the proxy contained material misstatements and omissions (*i.e.*, allegedly concealing the imminent departure of MultiPlan's largest client, which accounted for 35% of its revenues in 2019). Premised on these key facts, the complaint asserted various claims for breach of fiduciary duty. In MultiPlan's motion to dismiss, the defendants argued that the business judgment rule applied to their actions concerning the de-SPAC transaction and, therefore, shielded those actions from judicial review.

As an initial matter, Vice Chancellor Lori W. Will confirmed that "well-worn fiduciary principles" would be applied to plaintiffs' claims even though they pertained to the "novel" and nontraditional nature of a de-SPAC transaction. The Court signaled that despite their unique structure, on certain matters SPAC parties will need to engage with traditional corporate law standards applicable to Delaware fiduciaries.

In largely rejecting defendants' dismissal arguments, the Court applied the generous "reasonably conceivable" standard that governs a motion to dismiss and agreed that the entire fairness standard applied because (1) the de-SPAC transaction, including the opportunity for stockholders to redeem, was both a conflicted controller transaction and one in which stockholders were deprived of material information and (2) a majority of the board was conflicted because they were either self-interested due to their interest in the founder shares or lacked independence in some way from Klein. The entire fairness standard is Delaware's "most onerous standard of review" and shifts the burden to defendant fiduciaries "to demonstrate that the challenged act or transaction was entirely fair to the corporation and its stockholders." In doing so, defendants must prove that both the price of the transaction and the course of dealing (including structure, negotiations, disclosures and timing) were fair. The entire fairness inquiry is fact intensive — almost without exception resulting in the lawsuit surviving past the motion-to-dismiss phase.

As to the "conflicted controller transaction" aspect, the Court reiterated that the sponsor's status as a controlling stockholder was insufficient, by itself, to trigger entire fairness. A controller also must either "stand on both sides" of the deal or "compete with the common stockholders for consideration." Here, the Court held that the facts alleged suggested the sponsor/controller was obtaining a "unique benefit" to the detriment of the minority, in particular because the sponsor's founder shares in this case offered an upside even in the event of a transaction that led to a decline in stock price—incentives that differed from those of other common stockholders.

The Court also held that a majority of the board approving the transaction was interested due to their economic interest in the same class of founder shares. A board majority was also found to lack independence from Klein due to significant business and familial connections, including (1) familial relationships (the sponsor's brother was a director), (2) professional relationships (another director was a managing director at a Klein-controlled company) and (3) service as a director on multiple Klein-sponsored SPAC boards (and receiving founders shares with each).

The Court acknowledged that some SPAC entities "have more bespoke structures intended to address conflicts," implicitly rejecting plaintiffs' contention that the very structure of SPAC transactions are "conflict-laden." The Court also highlighted that, in addition to plaintiffs' varied conflict allegations, the *MultiPlan* plaintiffs pled viable disclosure claims, alleging that stockholders lacked material information necessary to fully evaluate their redemption right. Specifically, plaintiffs alleged that a customer responsible for 35% of *MultiPlan*'s revenue was designing a product to compete with *MultiPlan*, obviating its need to be a *MultiPlan* customer and increasing future competition.

The Delaware Court of Chancery in MultiPlan*: Plaintiffs' claims "are reasonably conceivable because the Complaint alleges that the director defendants failed, disloyally, to disclose information necessary for the plaintiffs to knowledgeably exercise their redemption rights."*

This disclosure-related finding played a critical role in *MultiPlan* because of a unique SPAC feature: the opportunity to redeem. Unlike a traditional merger, where a stockholder is presented with a "deal or no deal" choice via a right to vote, a SPAC stockholder receives both a right to vote as well as a separate choice to (1) maintain his or her investment and own shares in the de-SPAC entity *or* (2) redeem the shares for the initial investment value (usually, $10/share), plus interest earned (here, $10.04/share). Some, including the defendants here, have argued that this feature—through which a stockholder affirmatively chooses to invest in the de-SPAC company or get his or her money back, separate from voting for or against the transaction — can limit liability for alleged breaches of fiduciary duties. That argument failed in *MultiPlan* in large part due to the disclosure allegations — *i.e.*, the Court found that the company's stockholders assessing their redemption rights were not fully informed.

The extreme nature of the conflicts alleged in *MultiPlan*, where members of the board as well as the financial advisor were closely linked to Klein, along with the allegations of substantial disclosure failures, likely means that this decision is not a bellwether of future SPAC cases. It remains to be seen how a SPAC that has made adequate disclosures and/or implemented alternative "bespoke structures" to mitigate sponsor and/or director conflicts would fare when faced with litigation and whether a SPAC stockholder's redemption right will ultimately prove to be a substantial liability shield.

Extraordinary Times May Still Call for Ordinary Measures: Delaware Supreme Court Affirms Buyer's Termination of $5.8 Billion Transaction

We discussed the Delaware Court of Chancery's decision in AB Stable *in our December 2020 issue of* Sidley Perspectives*.*

In December 2021, the Delaware Supreme Court affirmed Vice Chancellor Travis Laster's much-talked-of *AB Stable* post-trial decision, holding that the buyer of a $5.8 billion hotel portfolio could terminate the transaction due to, among other things, the seller's breach of an ordinary course covenant by making operational changes in response to the COVID-19 pandemic. The Supreme Court's affirmance provides critical guidance for the interpretation and navigation of such provisions, particularly in extraordinary times.

The at-issue merger agreement was signed in September 2019 and slated to close in April 2020. Shortly before the planned closing, and without obtaining the buyer's consent, the seller made "drastic" changes at its 15 hotels in response to COVID-19. These included (1) closing two hotels entirely, (2) gutting operations at 13 others, (3) terminating or furloughing staff and (4) cutting spending on marketing and capital expenditures. After the buyer refused to close, the seller sued, seeking specific performance to force a closing. The buyer responded with counterclaims contending, among other things, that it had no obligation to close due to the seller's breach of the ordinary course covenant.

Vice Chancellor Laster sided with the buyer, holding that it had validly terminated the merger agreement because the ordinary course covenant had been breached and a condition (related to issuance of title insurance) had failed. The Supreme Court did not reach the title insurance issues (and the trial court's related harsh criticism of the seller and its advisors) but affirmed the conclusion that the buyer was permitted to walk away on the basis of the ordinary course covenant breach and provided several pieces of guidance for participants and advisors in M&A transactions. Among them:

- **Consistent with Delaware's highly contractarian regime, ordinary course covenants will be interpreted literally.**
  - The covenant at issue required operation "in the ordinary course of business consistent with past practice in all material respects." The Supreme Court looked to dictionary definitions and precedent to interpret "ordinary course" as the "normal and ordinary routine of conducting business" and explained that such provisions prevent a seller "from taking any actions that materially change the nature or quality of the business that

The fact that the seller made changes that were reasonable in the face of the COVID-19 pandemic was irrelevant. What mattered was that those changes constituted a material change in the nature and quality of the business being sold as compared to its prior operations.

is being purchased, whether or not those changes were related to misconduct." As a consequence, the fact that the seller made changes that were *reasonable* in the face of the COVID-19 pandemic was irrelevant. What mattered was that those changes constituted a material change in the nature and quality of the business being sold as compared to its prior operations.

- Should parties want "ordinary course" obligations to be measured with reference to a history beyond that of just the target company (*e.g.*, measured against the actions of an industry), or qualified by a "reasonableness" standard, they should say so expressly in the contract.

- **Notice and consent requirements should not be taken lightly; the outcome may have been different had the seller sent a notice seeking the buyer's consent in advance.**
  - The Supreme Court's several-page discussion of notice requirements warrants some focus for its practical guidance.
  - The seller requested the buyer's consent to the material changes (*e.g.*, closing two hotels) two weeks after they were implemented and argued that this did not constitute a material breach and, alternatively, that the buyer had "unreasonably withheld" its consent (itself a breach of the agreement).
  - The Supreme Court disagreed and reiterated Vice Chancellor Laster's reminder that "compliance with a notice requirement is not an empty formality."
  - Although the seller was "not required to run its hotels into the ground to comply with the Sale Agreement" in the face of a global pandemic, it had a contractual obligation to seek consent *before* making changes (consent the buyer could not "unreasonably" withhold).
  - This holding will likely serve as a nudge for sell-side companies and practitioners to err on the side of requesting that a buyer consent to operational changes (at least when coupled with a buyer's obligation to not "unreasonably" withhold such consent). The contours of what would be "unreasonable" in this setting, however, were not addressed, leaving more guidance on that question for another day.
- **Material adverse effect (MAE) provisions are inherently distinct from ordinary course covenants.**
  - The seller had argued that because pandemic risk was allocated to the buyer via the MAE, the ordinary course covenant should be read in tandem with the MAE provision. Otherwise stated, the seller claimed that where an ordinary course covenant overlaps with an MAE allocation of risk to the buyer, the ordinary course covenant should be read to import that heightened standard.
  - Here again the Supreme Court affirmed Vice Chancellor Laster's rejection of this position, which rested on the plain language of each provision (and the distinct purposes of those provisions in practice).
  - Unless written to operate in tandem (*e.g.*, by restricting an ordinary course breach to events that rise to the level of an MAE), ordinary course and MAE provisions will be interpreted separately, pursuant to their plain language.
  - Further, the Supreme Court confirmed that ordinary course and MAE provisions "serve different purposes," with the former providing assurance that the buyer "has not materially changed its business or business practices during the pendency of the transaction" while the latter "allocates the risk of changes in the target company's valuation."

We discussed the Delaware Court of Chancery's decision in CytoDyn *in our December 2021 [issue](#) of* Sidley Perspectives.

Court to Activists (Again): Follow the Rules or Suffer the Consequences

In February 2022, Vice Chancellor Lori W. Will issued a post-trial decision affirming the Lee Enterprises, Inc. board of directors' rejection of a stockholder nomination of directors because, in contravention of Lee's bylaws, the notice neither was submitted by a stockholder of record nor utilized the company's required nominee questionnaire forms. This decision in *Strategic Investment Opportunities LLC v. Lee Enterprises, Inc.* further underscores the Court of Chancery's recent decision in *Rosenbaum v. CytoDyn, Inc.*, in which the Court upheld a board's decision to reject a nomination notice for failure to comply with information requirements in the governing bylaws.

As in *CytoDyn*, the bylaws at issue in *Lee Enterprises* were adopted on a clear day, here approximately two years before the nomination was received. Lee Enterprises' bylaws provided that, among other things, nomination notices could be submitted by stockholders of record. But here, while the plaintiff was a beneficial owner of stock in Lee Enterprises, it was not a stockholder of record at the time it submitted its nomination notice. Lee Enterprises' bylaws further provided that nomination notices must include Lee Enterprises' nominee questionnaire forms, which would be made available to record holders. Given that the plaintiff was not a record holder, it was unable to obtain the company's required questionnaire forms. Nonetheless, on the date on which nomination notices were due under the bylaws, the plaintiff submitted a nomination notice reflecting that it was the beneficial owner and that Cede & Co. was the record holder, and it also submitted alternative forms that it characterized as "comprehensive customary written questionnaire[s]…that [are] substantially similar in scope to the forms of written questionnaires provided by a company's secretary in like situations." Six days after the deadline for submitting nomination notices, the plaintiff became a stockholder of record.

After the board of Lee Enterprises rejected the nomination notice for failure to comply with the company's bylaws, the stockholder plaintiff filed its lawsuit, seeking a declaration that its nomination materials were valid, together with a supporting injunction.

Following expedited proceedings, Vice Chancellor Will held that the rejection of the notice was contractually proper. The Court then shifted to an equitable analysis to consider whether the rejection should nonetheless be set aside due to any manipulative or other improper conduct by the company or the board. Applying an enhanced scrutiny standard of review, the Court found no evidence of manipulative conduct. Rather, the plaintiff delayed in its efforts to organize information necessary to submit a timely nomination notice inclusive of all information required under the bylaws. As a result, the plaintiff's materials did not comply with the bylaws, and the board was within its rights to reject the plaintiff's notice.

Accordingly, *Lee Enterprises* is yet another reminder of the importance of advance notice bylaws in director elections, including that reasonable information requirements will be enforced, absent extreme circumstances. As in *CytoDyn*, and seen again in *Lee Enterprises*, adoption of such measures on a clear day is paramount.

CORPORATE GOVERNANCE DEVELOPMENTS

Institutional Investors Continue to Increase Their Expectations Regarding Board Diversity

Key institutional investors are continuing to scrutinize board composition and refreshment and have expanded their focus beyond increasing gender diversity. Recently the so-called "Big Three" asset managers—BlackRock, Vanguard and State Street—each released enhanced expectations with respect to board diversity and related disclosures that are summarized below.

Insufficient board diversity was the primary reason BlackRock voted against directors in 2021.

According to BlackRock's 2022 proxy voting guidelines:

- Boards are "encouraged" to have at least two female directors and at least one director from an underrepresented group and "should aspire" to 30% diversity of membership.[5]
- BlackRock may vote against members of the nominating/governance committee of a company that "has not adequately accounted for diversity in its board composition within a reasonable timeframe."
- Companies should disclose diversity aspects relevant to the business and how the board's diversity characteristics align with the long-term strategy and business model as well as the process by which director candidates are identified and selected, including whether an outside firm was engaged and whether a diverse slate is considered for all board seats.

Under Vanguard's proxy voting policy that took effect on March 1, 2022:

- Boards should represent diversity of personal characteristics including at least gender, race and ethnicity (disclosed on an aggregate or individual director basis) as well as other attributes including tenure, skills and experience (disclosed on an individual basis).
- Vanguard may vote against the nominating and/or governance committee chair (or other director if needed) if a company's board is making insufficient progress in its diversity composition and/or in addressing its board diversity-related disclosures, taking into account applicable market regulations and expectations along with additional company-specific context.
- Vanguard generally will vote for a shareholder proposal seeking enhanced disclosure about board diversity if (1) it requests disclosure about directors' diversity of personal characteristics (including gender, race, ethnicity and national origin) or skills and qualifications and such information is not already disclosed, (2) it asks a company to adopt policies designed to ensure appropriate board diversity and they do not already exist, and (3) it is not overly prescriptive about what skills should be included or how the requested information must be presented.

State Street Global Advisors (SSGA) issued Guidance on Diversity Disclosures and Practices in January 2022 setting forth the following new expectations and policies:

SSGA noted that in future years it intends to expand its diversity efforts to the workforce and executive levels.

- Companies in all markets and indices should have at least one female director (formerly this applied only to Russell 3000 companies) and, beginning in 2023, Russell 3000 companies should have at least 30% female directors. If these requirements are not met, SSGA may vote against the nominating committee chair (or all nominating committee members if the failure lasts for three consecutive years). SSGA may waive the policy if a company provides a specific, timebound plan to add the requisite number of women to the board.
- S&P 500 companies should have at least one director from an underrepresented racial or ethnic community. SSGA will vote against the nominating or governance committee chair at S&P 500 companies that do not meet this requirement.
- Companies should publicly disclose efforts to achieve diverse representation at the board level (including race, ethnicity and gender at a minimum), including how the nominating committee ensures that diverse candidates are considered in board recruitment. Companies should also disclose the role diversity plays in strategy, what diversity goals exist, and how the board executes its oversight role in diversity and inclusion.
- When analyzing diversity-related shareholder proposals, SSGA will assess whether the company's public disclosures demonstrate alignment with five expectations specified in the guidance: (1) board oversight of diversity efforts, (2) the company's approach to promoting diversity and how it integrates with overall business strategy, (3) diversity goals and

5 "Underrepresented group" includes the following: (1) individuals who identify as Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, or Native Hawaiian or Pacific Islander, (2) individuals who identify as LGBTQ+, (3) individuals who identify as underrepresented based on national, Indigenous, religious or cultural identity and (4) individuals with disabilities and veterans.

programs and policies in place to measure and achieve the goals, (4) certain measures of the diversity of the company's global workforce and the board and (5) efforts to achieve diverse representation at the board level. If a company is aligned with four or five of SSGA's stated expectations, it will "most likely" vote against the diversity-related proposal. If a company is aligned with only three or fewer of the expectations, SSGA will most likely engage with the company to seek greater alignment. If a company is not receptive, SSGA will most likely support a proposal that would meaningfully advance diversity-related disclosures.

Public company boards—particularly those with minimal diversity—should familiarize themselves with the guidelines and policies of their institutional investors to be in a position to explain conformity with (or deviations from) their expectations about board diversity.

SEC DEVELOPMENTS

SEC Proposes Far-Reaching Rules for "Enhancement and Standardization" of Climate-Related Disclosures

On March 21, 2022, the SEC issued proposed rules that would require public companies to include extensive climate-related information in their registration statements and periodic reports. The rules would require disclosure of:

- Climate-related risks reasonably likely to have a material impact on the company's business or consolidated financial statements, within the existing definition of materiality.
- The actual and potential impacts of material climate-related risks on a company's strategy, business model and outlook.
- The manner in which a company's board oversees climate-related risks and management's role in assessing and managing those risks.
- Processes for identifying, assessing and managing climate-related risks.
- Various climate-related financial statement metrics.
- Climate-related targets and goals, if the company has set them.
- Direct (Scope 1) and indirect (Scope 2) greenhouse gas (GHG) emissions data—as well as additional upstream/downstream indirect GHG emissions (Scope 3) if material or if the company has set targets for Scope 3 emissions.

The proposed climate-related disclosure rules are sweeping and would impose substantial new disclosure responsibilities on public companies in their SEC filings.

The proposed rules would impose substantial new disclosure responsibilities on public companies in their SEC filings. Whereas many public companies already publish voluntary climate-related disclosures in reports outside of SEC filings, the proposed rules would require them to disclose such information in SEC filings according to rigorous methods and standards. Certain of this information would be subject to attestation or independent audit requirements.

The need to produce new disclosures will compel companies to apply added attentiveness to climate-related issues and may necessitate stepped-up engagement with external experts in climate change and climate accounting. While the proposed rules pertain only to disclosures, if adopted, they would impact operations by indirectly compelling companies to take action, to the extent they are not already doing so, to put monitoring, accounting, planning and governance practices in place to enable them to satisfy the proposed disclosure requirements.

The SEC will accept public comments on the proposal until the later of May 20, 2022 or 30 days after the proposing release is published in the *Federal Register*. If the proposed rules are adopted in late 2022, large accelerated filers would not be subject to them until filings made in 2024 that include 2023 financial statements. For a more comprehensive discussion of the proposed rules and practical guidance for companies considering next steps, see our Sidley Update available here.

SEC Proposes New Cybersecurity Risk Management and Governance Rules for Public Companies

In March 2022, the SEC proposed new cybersecurity rules to enhance and standardize disclosures regarding cybersecurity risk management, strategy, governance and incident reporting by public companies. The SEC proposal would continue to ratchet up cybersecurity as an increasingly critical dimension of corporate governance.

Weeks after the SEC proposed the new cybersecurity rules, Congress passed the Cyber Incident Reporting for Critical Infrastructure Act of 2022 which will require critical infrastructure entities to report material cybersecurity incidents and ransomware payments to the Cybersecurity and Infrastructure Security Agency. See this Sidley Update for more information.

Key takeaways from the SEC's release include the following:

- **Reporting material cybersecurity incidents within four days.** The SEC would modify the Form 8-K reporting requirements to include reporting of any material cybersecurity incident to the SEC within four business days after the registrant determines it has experienced such an incident. Critically, the time to disclose is tied to a determination of materiality and not the date of the initial discovery of an incident that could, with time and after investigation, become a material event (or be determined not to be material). The proposed rules include a nonexclusive list of cybersecurity events that may require disclosure, all of which may happen with frequency in today's cyberthreat environment despite reasonable information security programs and defenses. An untimely filing of the proposed new 8-K item would not affect Form S-3 eligibility.
- **Updating previously reported incidents.** The proposed rules will also require updates about previously reported material cybersecurity incidents through registrant's Form 10-Ks and 10-Qs for the period in which the update occurred, such as the following nonexclusive examples: any material impact of the incident (or potential material future impacts) on the registrant's operations and financial condition; whether the registrant has remediated or is remediating the incident; and any changes in the registrant's policies and procedures as a result of the cybersecurity incident and how the incident may have informed such changes. In addition, the proposed rules would require disclosure when a series of previously undisclosed individually immaterial cybersecurity incidents become material in the aggregate.
- **Requiring disclosure of cybersecurity risk management and strategy.** The SEC proposes to amend Form 10-K to require disclosures of a registrant's cybersecurity risk management systems, which may include its policies and procedures for identifying, assessing and managing the risks. The proposed rules include a nonexclusive list of risk management strategies, policies and procedures that may require disclosure.
- **Requiring disclosures concerning cybersecurity governance.** The SEC proposes to amend Form 10-K to require a description of the board's oversight of cybersecurity risk as well as a description of management's role in assessing and managing cybersecurity risks, the relevant expertise of such management and its role in implementing the registrant's cybersecurity policies, procedures and strategies. The proposed rules include a nonexclusive list of items that may be included in the description.
- **Requiring disclosures concerning board cybersecurity expertise.** The SEC proposes to amend Item 407 of Regulation S-K to require a description of the cybersecurity expertise of a registrant's board.

Commissioner Hester Peirce published a statement dissenting on the proposed rules. She argued that the SEC's role with respect to cybersecurity is limited and that the proposed rules act as "an unprecedented micromanagement by the Commission of the composition and functioning of both the boards of directors and management of public companies."

The SEC will accept public comments on the proposal until May 9, 2022. For more information about the proposed rules, see the Sidley Update available here.

SIDLEY RESOURCES

Corporate Governance

Should Highly Regulated Public Companies Have Board-Level Compliance Committees? In this *CEP Magazine* article, Sidley partners Holly J. Gregory and Paul E. Kalb, MD, the co-chair of Sidley's Executive Compensation and Corporate Governance practice and the global head of Sidley's Healthcare and FDA Group, respectively, discuss the considerations evaluating whether highly regulated public companies should have board-level compliance committees.

Best Practices for Minute-Taking: Three Lessons from Recent Caremark Decisions (March 2, 2022). This Sidley blog post reviews, from a corporate record-keeping perspective, themes drawn from a selection of recent cases in which Delaware courts permitted cases to proceed on *Caremark* theories and implications for best practices in light of these themes.

SEC Rulemaking

SEC Proposes to Shorten Beneficial Ownership Reporting Deadlines, Expand Scope — How Will It Affect You? (February 24, 2022). As anticipated from Chair Gary Gensler's public comments, the SEC has proposed significant amendments to the Williams Act beneficial ownership reporting regime. If adopted, the amendments would shorten filing deadlines for Schedules 13D and 13G, require beneficial ownership reporting of shares underlying certain cash-settled derivatives, and expand aggregated ownership reporting requirements under the "group" concept. Coupled with separately proposed security-based swap reporting requirements, these rules would require many investors to implement significant changes to their compliance and monitoring systems to address what would be a far more comprehensive equity position reporting regime.

SEC Reporting

Preparing Your 2021 Form 10-K: A Summary of Recent Key Disclosure Developments, Priorities and Trends (February 4, 2022). This Sidley Practice Note highlights certain key disclosure considerations for public companies preparing their annual reports on Form 10-K for fiscal year 2021, including recent amendments to SEC disclosure rules and other developments that impact 2021 Form 10-K filings, as well as certain significant disclosure trends and current areas of SEC staff focus for disclosures.

Cybersecurity

Congress Passes Cyber Incident Reporting for Critical Infrastructure Act of 2022 (March 21, 2022). Congress has passed a significant new cybersecurity law that will require critical infrastructure entities to report material cybersecurity incidents and ransomware payments to the Cybersecurity and Infrastructure Security Agency. The agency will issue a final rule clarifying the scope of the requirement as well as detailing what reports must include. The regulation could affect a diverse set of industries, including manufacturing, chemicals, energy, transportation, telecommunications, financial services, agriculture, information technology and healthcare.

Antitrust; HSR

FTC Releases 2022 Thresholds for Hart-Scott-Rodino Filings and Interlocking Directorates, Raises Maximum Per Diem HSR Penalty (January 27, 2022). Effective February 23, 2022, the minimum "size of transaction" threshold for any acquisition of voting securities, noncorporate interests or assets not exempt from HSR notification requirements increased from $92 million to $101 million. Other thresholds related to these filings and to Clayton Act Section 8's prohibition against interlocking directorates were also adjusted for 2022. Additionally, the maximum per diem civil penalty amount for HSR violations is now $46,517 per day.

Litigation

A Delaware Section 220 Checklist: Seven Cases Every Practitioner Should Know (March 9, 2022). This Sidley blog post highlights decisions that have shaped legal practice concerning Section 220 of the Delaware General Corporation Law, which allows stockholders to inspect corporate books and records under certain circumstances.

Litigation Trends in Delaware and How Businesses and Boards Can Mitigate Risk (February 17, 2022). New structures, new rules? Delaware's Court of Chancery provides guidance on disclosure, conflicts and risk allocation. This Sidley podcast looks at the latest Delaware rulings and what they say about SPAC directors' fiduciary duty as well as COVID-19's effect on M&A deals and how corporations and boards can mitigate their liability.

Corporate Wrongdoing

DOJ Leadership Highlights Focus on Individual Culpability and Victims' Restitution in White-Collar Prosecutions (March 4, 2022). In recent keynote addresses to the American Bar Association Institute on White Collar Crime, U.S. Attorney General Merrick B. Garland and Assistant Attorney General Kenneth A. Polite Jr. forcefully underscored the DOJ's renewed focus on prosecuting individual defendants alongside their corporate counterparts. Noting that the Department's "first priority in corporate criminal cases" would be the pursuit of "individual accountability," Garland and Polite cautioned practitioners that the DOJ was investing significant financial resources into "obtaining individual convictions rather than accepting big-dollar corporate dispositions."

With Successful Prosecution of CEO, DOJ Raises the Stakes for Corporate Executives (February 10, 2022). The conviction of the 78-year-old former CEO of Rochester Drug Cooperative for conspiracy to unlawfully distribute opioids under the Controlled Substances Act, which carries a mandatory minimum sentence of 10 years' imprisonment, is a dramatic escalation of two key DOJ enforcement trends: seeking individual accountability for corporate wrongdoing and the pursuit of novel theories of liability in what DOJ has described as a pursuit of "entities and individuals up and down the prescription opioid supply chain." The prosecution and conviction are also important reminders of the need for corporate management and boards of directors to take action when compliance programs identify signals of risk.

SIDLEY EVENTS

Private Funds Program 2022

April 5 | New York, N.Y. and Live Webinar Broadcast

Sidley's 2022 Private Funds program will be held in Sidley's New York office and via live webinar broadcast on April 5. The annual program will feature a series of panel discussions and videos featuring Sidley lawyers and key industry representatives from around the world as they offer global perspectives on the state of the private funds industry. This year's program will include presentations covering a range of topics, including hedge funds, private equity funds, real estate funds, alternative investments, digital assets, ESG investing, and litigation, enforcement, regulatory and compliance updates. For more information, please contact nyevents@sidley.com.

Privacy & Cybersecurity Roundtable

April 11 | Washington, D.C.

Sidley will host its annual Privacy & Cybersecurity Roundtable at its Washington, D.C. office on April 11. The afternoon program will focus on the latest developments in privacy, data protection and cybersecurity and be followed by a networking reception. For more information, please contact dcevents@sidley.com.

SIDLEY SPEAKERS

70th Annual Spring Meeting of the American Bar Association Antitrust Law Section

April 5-8 | Washington, D.C.

Lawyers from Sidley's Antitrust/Competition practice group will speak at the American Bar Association Antitrust Law Section's 70th Annual Spring Meeting in Washington, D.C. on April 5-8. Karen Kazmerzak will speak on a panel titled *Populist Antitrust-The Buck Stops Where?*, Jim Lowe will chair and moderate a panel titled *Is the U.S. Falling Behind?*, and Tim Muris will speak on a panel titled *Antitrust and SEPs: What's Next?* Click here for more information.

Parsing the SEC's New Climate Disclosure Proposal

April 12 | Webcast

Sonia Gupta Barros, a partner in Sidley's Capital Markets, Corporate Governance and Securities Enforcement and Regulatory Practices and co-chair of the firm's Public Company Advisory practice, will speak about the SEC's newly proposed climate disclosure rules on a webcast hosted by TheCorporateCounsel.net on April 12. Click here for more information.

2022 Global Corporate Venturing & Innovation Summit

June 22-23 | Monterey, CA

Sandi Knox, leader of Sidley's Corporate Venture Capital practice, will lead a panel discussion titled *The Path to Prosperity—Deal Sourcing & CVC Investing in 2022 and Beyond* on June 22 at the 2022 Global Corporate Venturing & Innovation Summit. Corporate venture leaders will discuss how they are sourcing deals and leading investments against the backdrop of the COVID-19 pandemic to support innovation advancement for their parent companies. Click here for more information or to register.

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