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Horizon 2020

Summary of key issues, challenges, insights and recommendations for boards of publicly traded companies in the US in 2020

Risk management

Adequacy of board oversight

- Plaintiffs obtained significant victories in 2019 in actions claiming that boards had failed to adequately oversee risks. This marked a meaningful departure from past trends in these cases.
- Risks ranging from cybersecurity to connections to the opioid crisis, climate change to product development, all present fodder for future challenges by plaintiffs.
- Directors must identify intrinsic risks to the business, set up board-level compliance and monitoring systems, and engage with management and the company's consultants to assure that these mechanisms are functional. Although complete effectiveness is not practicable or required to successfully defend a claim for inadequate oversight (e.g. in the realm of cybersecurity where a bulletproof system does not exist), the directors need to receive regular reports and ask questions about the efficacy of these risk management efforts.
- Equally important is for all of the above to be well-documented in board minutes and for information to be treated in a manner that does not jeopardize applicable privileges.

Managing enforcement risks

- Enforcement authorities around the world continue to cooperate and take advantage of vulnerabilities for companies arising from inconsistent rules between jurisdictions (e.g. on requirements to produce materials for the authorities, data protection and privilege). An understanding of the full set of standards is critical. Differences in data protection rules, for example, can result in vastly different impacts on companies depending on where their data is stored.
- We expect to see prosecutors continue to trend toward pursuit of actions against individual directors and officers, rather than the corporate entity itself.
- The issue of when to self-report continues to evolve and it is critical to stay on top of the latest pronouncements, including the 2019 DOJ revisions.

Managing tax risks

- New tax regimes relating to digital goods and services, as well as cloud computing, are being implemented and will impact strategic plans and alternatives. Boards need to be familiar with these impacts.

Specific HR risks to consider

- Treatment of the deductibility of compensation to executives under Section 162(m) of the Internal Revenue Code, whistleblower protections, and safeguards for gig workers are all areas ripe for missteps due to changing interpretations, new rules in and outside the US and open questions. Boards need to understand the impacts on their decision-making.

Understanding cyber and data risks

- Recent fines of US-based companies for GDPR violations, fines linked to transfers of data from Europe to the US, FTC enforcement actions for misuse of personal data, imminent new restrictions under the laws of Brazil, China, California, New York (and potentially other states) and a potential new US federal statute all point toward a need for boards to regularly revisit the impact of these rules on their business model and on their ability to comply.
- Although the US continues to lack a comprehensive data protection regime, the patchwork of applicable statutes has resulted in a series of standards and guidelines that, with proper planning, can be navigated.

Who holds your debt and what's going on with your covenant compliance?

- Audit committees need to keep track not only of potential defaults but also of the likelihood that creditors that hold credit default swaps in the company may be able to obtain sufficient amounts of their debt to force a technical default.
- Audit committees should similarly be pushing to see whether any debt instruments that are more than a year old could be refinanced at de minimis cost with new debt that has much more favorable covenants in light of recent shifts in market practice on covenants.

For a full discussion of these topics, see **Trends in Delaware litigation**, **Priority areas for global enforcers**, **Taxing the digital economy**, **Employee benefits: the forward view** and **Debt forecast**.

Broad impact of new national security and foreign investment rules

Any sharing with third parties relating to emerging technologies – most prominently artificial intelligence, deep learning, robotics, blockchain, gene-editing, and 5G, but potentially including many other dynamic areas – is potentially subject to a new stream of US Commerce Department regulations, as well as the new rules under CFIUS. These rules govern export controls and a broad range of transactions, not just wholeco sales.

Boards need to be briefed on how these new rules are impacting their corporations' strategic plans and alternatives. The impacts cannot be understated.

The inking of a trade deal with China will not alter these concerns and they are not limited only to China-related exports and transactions.

Similar legislation in the UK and Europe is in the process of being implemented and will add yet another layer to this need to reassess strategic plans and alternatives.

For a full discussion of this topic, see **Navigating foreign investment rules**.

Strategic alternatives challenges

Regulatory, political and macro-economic uncertainties will continue to make it hard for management to give boards a solid set of internal forecasts to use as a basis for selecting the best strategic alternative or sticking with the standalone plan. Boards nonetheless have to push management for helpful internal forecasts, including transparency on probability and risks. It is important for boards to understand and for minutes to memorialize whether an internal forecast was prepared as an aspirational case, as a case based on an outside consultant's preliminary understandings, or as the most likely estimate by management of the future.

A number of directors and advisers have been caught up in litigation recently that has focused on alleged manipulation of internal forecasts, prompted largely by last-minute changes to forecasts that appeared to be implemented to back the board into a fully-baked transaction.

When assessing the LBO landscape, we will increasingly see LP-type investors, which often operate through unfunded special purpose vehicles, play significant roles. Boards of potential targets need to press their advisers to assure that the directors can understand where the money for buyout is coming from and that there is acceptable execution risk on disbursement and regulatory (e.g. foreign investment) risks that come with these LP-type investors.

Activism 2020

We expect activists to continue their campaigns against large caps, given recent successes and the ease of exit (see, e.g. Elliott's activist campaign at AT&T based on holdings in the 1 percent range valued at just over $3 billion).

Activists will continue to be a risk for announced M&A transactions, especially on the buyside when shareholder approval is needed under US stock exchange rules due to the use of stock consideration. Selling the deal to your investors (and not waiting until the proxy statement to do so) is more critical than ever. We are regularly recommending that clients include more detail on process and bases for valuation in the initial deal announcement, and that clients launch straight into full-on shareholder engagement roadshows in support of a merger commencing on the day of announcement.

Activists are increasingly advocating, straight out of the box, for the sale of the entire company. Often this approach is uninformed about market dynamics and solely disruptive. Understanding that an activist's presence poses this risk – and pre-emptively discussing with investors the misunderstandings that underlie the view that a quick sale would serve investors well – is advisable.

Actively managed funds, ranging from Wellington to T.Rowe Price and Neuberger Berman, are no longer shy about taking on the role of activist when they think change is needed. Just because you do not have a brand-name activist in your stockholder profile, does not mean that you do not have a potential activist lurking there.

Activists continue to be able to put together quickly "single name" funds to target a specific activist investment (including for large caps).

Look out for the growing pool of first-time activists, with which it can be especially difficult to reach a quick settlement, due to their desire to generate media attention.

For a full discussion of these themes, see **Trends in stockholder activism**.

Director conflicts – need to focus on resolving overlaps

Boards usually do a good job of spotting related-party transactions and assuring that conflicted directors are walled off appropriately. But, with the increasing dynamism and expansion of the scope of standalone business plans and of the personal pursuits, investments and relationships of individual directors, boards need to do a better job of spotting overlaps between the corporation's plans and the lives of their directors outside the boardroom. These overlaps can lead to dual fiduciary scenarios where a director is bound both to the corporation and to a third-party entity in connection with the same subject matter, even though there is no related-party transaction. Resolving these scenarios requires foresight, agility and lots of open communication and transparency. As a first step, your corporation's D&O questionnaires should be enhanced to assure they capture these issues and companies should devise a mechanism for capturing them periodically.

Vulnerability of personal communications by directors

Courts have become increasingly sympathetic to the use of Section 220 requests by shareholders to obtain minutes and other information about board processes (including communications outside the board room to supplement the minutes, particularly if those minutes are brief).

It is imperative to assure that minutes are sufficiently detailed and complete to mitigate demands for text messages and other personal communications.

For a full discussion of this topic,
see **Trends in Delaware Litigation**.

Oversight of minority investments by directors

Corporations now regularly have numerous minority investments in non-controlled companies as an alternative to having their cash earn low returns in bank accounts. These investments take the forms of venture capital-type investments, PIPEs and joint ventures. Often they are coupled with commercial and IP arrangements.

Boards should assure these investments are consistent with their articulated strategic objectives and are not unsupervised, that they do not subject the corporation to undue risks related to internal control, accounting, financial reporting or compliance issues, and that they do not put the corporation's brand at risk.

Presence of company personnel on boards of these non-controlled third-party entities can give rise to further complications, including corporate opportunity conflicts and irreconcilable tensions between duties of confidentiality, candor and loyalties to the corporation and to the third-party entity.

For a full discussion of this topic,
see **Corporate minority investments**.

Board elections and shareholder proposals and engagement

Shareholder proposals

- Given the linkage between recommendations to vote against directors and their failure to implement shareholder proposals that receive majority support, it is advisable for directors to stay on top of trends in shareholder proposals.
- Key areas of focus for proposals (and where there is the greatest likelihood that proposals will receive majority support) include: modification of the charter to permit shareholders to act by written consent and lowering the threshold to permit shareholders to call a special meeting. If such a proposal receives majority support, boards should keep in mind that there is a spectrum of ways of implementing these concepts and that the details will have a direct linkage to how much these changes will reduce their defense protections.
- E&S proposals will remain prominent but we expect companies to often be able to negotiate a withdrawal after engagement with the shareholder proponents.
- We expect a significant push this coming proxy season to force corporations to adopt a version of the Rooney Rule to promote diversity. Again, engagement will be important to pre-empting a vote on these proposals.
- In addition, recent SEC developments relating to the requirements for making and excluding shareholder proposals will impact tactics when responding to them.

We do not expect the new SEC rules on proxy advisory firms to rein in the ability of ISS and Glass Lewis to easily swing at least 30 percent of the voting power at most publicly traded companies. Accordingly, we continue to advise in favor of engagement with institutional investors during the off-season so that they have a direct relationship with the company beyond the ISS report. We further advise in favor of aggressive efforts to shape the recommendations of the proxy advisory firms by taking steps to correct their misunderstandings and impressing upon them (including through proxy statement disclosure) the extent to which the board's positions on controversial matters are part of a well-founded corporate strategy and responsive to the direct feedback from recent, broad-based shareholder engagement.

Compensation and employee benefits related matters

- A weak showing (anything below 90 percent support) on a "Say on Pay" vote will function as a sign of vulnerability that will make the board seem more inviting to activists seeking to displace one or two directors.
- Designing appropriate "pay for performance" arrangements and taking into account ISS's new "economic value-added" metric will be critical to successfully navigating shareholder scrutiny of compensation arrangements.
- In addition, shareholder proposals about employment practices pose areas of risk for boards if not actively managed.

Diversity of tenure (not average tenure), as well as diversity of skill-sets, employment backgrounds and race/ethnicity of directors are, for many institutional investors, key variables for the board to manage through careful long-term planning of board composition.

For a full discussion of these topics,
see **Shareholder proposals** and
Employee benefits: the forward view.

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Human capital management

Recruiting, training and retaining employees is critical to corporate success and institutional investors are now paying specific attention to what boards are doing to manage these issues.

Directors should be asking questions, receiving reports and reviewing disclosure about workforce stability and satisfaction, hiring and promotion, training, skills and capabilities, health and safety, culture initiatives, compensation, and diversity.

For a full discussion of this topic, including emerging guidance from the SEC and institutional investors, see Leveraging talent for growth.

Environment and sustainability (E&S) post for directors

Assets under management by impact investors has outgrown by a significant margin those devoted to hedge fund activist equity strategies. In addition, investors and their intermediaries have gotten better at being able to assess how corporations are performing on this front. Nonetheless, exactly what investors and regulators want from companies on E&S remains dispersed, and therefore corporations still have the opportunity to dictate their own metrics and narrative within reason. Investors do not want to hear about how many recycling bins you have – they want to understand the interplay between these matters and the success of your long-term standalone business plan.

This is an area for boards to oversee, not only to manage investor expectations but also as part of risk oversight for the business and to avoid getting caught by new trends in plaintiffs' litigation being brought based on alleged common law torts, misleading disclosure and to challenge the granting of important permits.

Boards further need to be vigilant to assure that the guidance and growth plans that they are endorsing do not conflict with their concurrent commitments from an E&S perspective.

As boards respond to shareholder pressure in this area and become more refined in their commitments, we expect that (if Delaware amends some provisions of its public benefit corporation (PBC) statute to harmonize the provisions for conversion to a PBC with other charter amendments) we will start to see more boards seriously consider the upsides of converting to a PBC, including the increased insulation from liability and the fiduciary duty flexibility that the PBC regime offers.

In the meantime, the fast-growing market for "sustainability linked loans" ought to be taken into account by audit committees when considering capital allocation and balance sheet management.

For a full discussion of these matters, see What sustainability means for business, Shareholder proposals, Reforming the corporation, and Debt forecast.