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PROXY SEASON

Ten Tips for Minimizing the SEC's Comments on Your Proxy Statement

By Jing Tong and Delery Perret

In many aspects of the corporate world, time is of the essence. That is especially true in a proxy contest when the parties to the contest—the target company and the activist shareholder—compete to get their own proxy statements to shareholders first so they can start gathering votes from shareholders at the earliest time possible.

However, the almost inevitable review of the proxy statements by the Staff of the Securities and Exchange Commission (SEC) and the effort to clear the Staff's comments can frequently take longer than expected. The printing and mailing of proxy statements can sometimes be delayed beyond the expiration of the 10-day waiting period under Rule 14a-6(a) of the Securities Exchange Act of 1934.[1] In this article, we analyze some of the most commonly received comments from the Staff on proxy statements for contested shareholder meetings and explain how those comments can be avoided through careful drafting.

Avoid Relying on Rule 14a-5(C) Prior To the Registrant's Distribution of Its Proxy Statement

Many activist shareholders rely on Rule 14a-5(c) to incorporate certain information from the registrant's proxy statement.[2] Such information may include information about the registrant's incumbent directors and officers, including their biographical information (Item 401) and compensation (Item 402), related party transactions (Item 404), compliance with Section 16(a) (Item 405), corporate governance (Item 407) or insider trading arrangements and polices (Item 408). We do not recommend that practice, as it is both unnecessary and likely will get commented on by the Staff.

None of the aforementioned Items of Regulation S-K actually require the activist shareholder to disclose information about the registrant's incumbent directors or officers. For example, Item 7 of the Schedule 14A, which cross-references Items 401, 404(a), 401(b), 405, 407, and 408(b) of Regulation S-K, clearly provides that "[i]f . . . the solicitation is made on behalf of persons other than the registrant, the information required need be furnished only *as to nominees of the persons making the solicitation*" (emphasis added).

When commenting on such Rule 14a-5(c) references, the Staff frequently asks the filing person to advise if it anticipates distributing its proxy statement before the registrant distributes the registrant's proxy statement.[3] The comment will also clarify that the filing person may not rely on Rule 14a-5(c) at any time prior to the registrant's distribution of its proxy statement, and accordingly will have to accept all legal risk in connection with distributing the initial definitive proxy statement without all required disclosures and have to undertake to subsequently provide any omitted information in order to mitigate the risk.

A simple affirmative answer to the comment may be sufficient, but the activist shareholder will then be faced with two unpleasant options: (1) delay the filing of its definitive proxy statement until the registrant has filed the registrant's definitive proxy

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statement, or (2) supplement its proxy statement with the omitted information based on the relevant disclosures in the registrant's proxy statement or other filings.

A better option for the activist shareholder is simply to eliminate the 14a-5(c) references. But be sure to follow Item 7(f) of the Schedule 14A, which requires a statement directing shareholders to refer to the registrant's proxy statement for information required by Item 7 with regard to the registrant's nominees.

As a related matter, information may only be incorporated by reference in the manner and to the extent specifically permitted in Schedule 14A.[4] For example, an activist disclosed in its proxy statement[5] that an entity affiliated with the participants was holding promissory notes from the registrant, and the proxy statement incorporated the description of the notes by reference to the registrant's Form 8-K. The Staff's comment[6] required a summary of the promissory notes to be added to the proxy statement, on the basis that incorporation by reference is not specifically permitted in Item 5 of Schedule 14A.

Identify Any Statements of Opinion or Belief As Such, and Ensure That There Exists aReasonable Factual Basis for All Such Statements

A common theme in the Staff's comments and an outgrowth of Rule 14a-9 is that "[e]ach statement or assertion of opinion or belief must be clearly characterized as such, and a reasonable factual basis must exist for each such opinion or belief."[7] The underlying concern is that an opinion that is not characterized as such may mislead shareholders into treating it as a fact and hence attributing more weight to it than it deserves. The Staff sometimes further states that "support for opinions or beliefs should be self-evident, disclosed in the proxy statement or provided to the Staff on a supplemental basis."[8]

Registrants and activist shareholders alike should ensure that any opinions, including statements related to performance or qualifications of one's own nominees or the other side's nominees, are qualified by phrases such as "we believe," "in our opinion," or "in our view." Further, make sure that support is included for opinions, or at least available when prompted by the Staff to provide.

It is not sufficient to merely characterize a statement as opinion when there is no reasonable factual basis for it. For example, in respect of poison pills, the Staff could ask the company to provide the basis for its statement that the poison pill is "in the company's best interests"[9] or ask the activist shareholder to show why it claims that the adoption of a pill constitutes the incumbent board's effort to "entrench"[10] itself. In such cases, the Staff sometimes allows the filing person to choose between providing support and withdrawing the statement in question.

Remember That Legal Statements, Like Other Statements, Require a Reasonable Factual Basis; Be Sure To Provide It Accordingly

Just as opinions of which side has nominated better candidates for the board of directors requires a reasonable factual basis under Rule 14a-9, discussions of what is permissible pursuant to the law or opinions on whether any law has been violated by the other side should be accompanied by a reasonable factual basis.

For example, an activist shareholder's proxy statement may claim or imply that the incumbent directors have breached their fiduciary duties or otherwise violated the applicable state law or federal securities laws. A potential comment from the Staff is to identify such breach or clarify what specific law has been violated and to provide an analysis of the violation.[11]

In anticipation of such comments, include clear and precise reference to the applicable law and an analysis of the relevant facts and law to show why you think such law has been violated. Although it may feel easier to simply say "under Delaware Law" when drafting a proxy statement, this could draw a comment during the review process.

Avoid Including Statements That Impugn Character ir Reputation without Factual Foundation

Similar to other comments regarding Rule 14a-9, the Staff frequently comments on statements that impugn the character, integrity or personal reputation of the other side's participants in the solicitation. Specifically, Note B to Rule 14a-9 includes as an example of what may be misleading "material which *directly or indirectly impugns character, integrity or personal reputation*, or *directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations*, without factual foundation" (emphasis added).

Below are some examples of character impugning statements that the Staff recently commented on:

- [The registrant's chairman] is an imperial chairman and has established an anti-shareholder culture that is exacerbating corporate dysfunction . . . and stifling organic growth.[12]
- These directors appear either completely beholden to [the registrant's chairman] or utterly oblivious to the unprecedented shareholder opposition to his continued leadership.[13]
- After years of value destruction and blatant disregard for good corporate governance and the best interests of the Company's stockholders, including the current Board's self-serving decision to delay the Annual Meeting without explanation . . . .[14]
- In our view, the Company's current directors . . . have repeatedly demonstrated that they are not capable and/or willing to conduct a credible and fully independent strategic review process, ...[15]
- [The registrant's CEO] has repeatedly . . . childishly ignored us.[16]
- The Activist's misleading press release of [date] . . . is silent on [his] real motivation and objective for initiating a costly and distracting proxy fight at our shareholders' expense.[17]

Accordingly, avoid making comments related to moral character, lack of qualifications and other negative qualities unless you also provide clear factual support. Further, avoid alleging illegal or immoral conduct without providing specific examples of such behavior.

Identify Participants Clearly and Avoid References To Anonymous Parties or Their Opinions

Item 4 of Schedule 14A requires the filing person to identify the participants in its solicitation. Instruction 3 of Item 4 lays out who should, and who should not, be treated as participants for the purposes of this Item.

The Staff's comments in this respect tend to focus on failure to identify persons that should be treated as participants.[18] Often this appears in the form of comments (1) asking for an explanation as to why a certain person was or was not identified as a participant or (2) asking that an unnamed shareholder or participant mentioned be clearly identified.

Accordingly, in order to avoid comments related to participant identities, it is important to carefully perform the analysis required by Instruction 3 to Item 4 to ensure that all participants are properly categorized and identified, and to avoid references to the opinions or characteristics of anonymous shareholders or participants.

Make Sure To Include All Required Information About Each Participant in Your Proxy Statement, Particularly in a Contested Situation

The Staff has issued numerous comments related to missing disclosures required by Items 4(b) and 5(b) of Schedule 14A, which are triggered by a proxy contest.[19] Companies facing a proxy contest for the first time tend to be unfamiliar with these requirements since they are not commonly seen in a normal proxy statement. In preparing the relevant disclosures, an important initial step is to make a thoughtful decision on who should be treated as participants in the solicitation.

When faced with an activism situation, a company sometimes prefers to form a working group that meets regularly to discuss updates and strategies relating to the solicitation. It is usually comprised of members of the company's core leadership, for example, its Chief Executive Officer, Chief Financial Officer, General Counsel, and Senior Vice President for Investor Relations, and outside advisors (legal, investment bankers, public relations, proxy solicitors, etc.).

The same group of company participants will likely also attend roadshow meetings with shareholders. Be thoughtful about who from the company should participate in these meetings as a regular attendee of these meetings should likely be treated as a participant in the company's solicitation.

Another pitfall is that when companies or activists do include these disclosures in their proxy statements, there is a tendency to consolidate these disclosures into one or two lengthy paragraphs without thoroughly verifying their truth. Before filing the proxy statement, the personnel preparing the disclosures need to ensure each participant has reviewed and confirmed that the disclosures are accurate to the extent applicable to that participant. Based on our experience, circulating a checklist or open items list well in advance of the filing date can be especially helpful.

If a Background Section Is Included, Ensure It Is Balanced and Contains a Reasonable Level of Detail

Proxy statements for contested annual meetings routinely include a "Background of the Solicitation" section that describes the prior contacts and interactions between the target company and the activist shareholder, which is usually not required. The Staff has indicated in prior correspondence with us that a background section is technically not required unless any action to be taken at the meeting falls under Item 14 of the Schedule 14A.[20]

However, the Staff occasionally requires a background section to be added even though Item 14 is not triggered. For example, in commenting[21] on the preliminary proxy statement filed by Sarissa Capital Catapult Fund LLC et al, the Staff asks the filing persons to include a background section "discussing the events and contacts between the parties leading up to this solicitation." The comment does not cite a rule or any item of the Schedule 14A, which leaves us in the dark about its rationale.

One possible explanation is that the activist shareholder filed its preliminary proxy statement after the target company had already filed its proxy statement, which included a background section, and the Staff wanted both sides to present the background in case shareholders fell victim to a one-sided story. In any event, if the other side has included a background section, it would make perfect strategic sense to include a background section for one's own proxy statement. Proxy advisory firms as well as shareholders care about whether the parties have taken any effort to communicate with each other and resolve their differences amicably, and a background section provide an ideal place for showcasing that in great detail.

If a decision has been made to include a background section, ensure it does not turn into a fertile ground for comments. The background section originated from Items 1005(b) and 1011(a)(1) of Regulation M-A. Item 1005(b) requires a description of any negotiations, transactions or material contracts during the past two years between the filing person and the subject company or its affiliates.

Item 1011(a)(1) requires the disclosure of any present or proposed material agreement, arrangement, understanding or relationship between the parties and their respective officers, directors, controlling persons or subsidiaries. It is important to make these disclosures in an accurate, complete and balanced manner even though there is a temptation to omit unfavorable events or other details. As illustration, the following is a list of sample SEC comments on the background section:

- Describe how and when the participants came into contact and ultimately decided to jointly conduct this solicitation.[22]

- Describe any settlement negotiations or discussions between members of the activist group and the company.[23]
- Include the factual basis for any information that may be construed as character impugning.[24]
- Describe the "various pathways for the Company to unlock value for stockholders" that [the activist shareholder] proposed to the Company's representatives on a given date.[25]
- Revise the description of the exchange of correspondence and telephone calls relating to the stockholder list to briefly describe all of the company's reasons for rejecting the activist shareholder's request.[26]
- Revise to disclose that the company invited each of the activist shareholder's nominees to be interviewed by members of the nominating and corporate governance committee of the board, and disclose whether the nominees have responded to such invitation.[27]

Describe the Basis for Rejecting a Shareholder's Nomination and, if a Lawsuit Is Pending, How Votes Will Be Treated Depending on the Outcome of the Lawsuit

If a company has determined to reject an activist shareholder's nomination notice, a conclusory statement that the purported nomination notice does not comply with the company's advance notice bylaw will not be sufficient and likely will result in the Staff asking for more detail. In response, the company will need to disclose the key deficiencies that were identified in the shareholder's nomination notice.

The Staff usually is not looking for an exhaustive list of all the deficiencies in the shareholder's nomination notice. Moreover, from the company's perspective, it is not necessarily a good strategy to be that forthcoming.

Sometimes an activist shareholder will file a lawsuit challenging the company's decision to reject its nomination notice. While the lawsuit is pending, the parties to the proxy contest may choose to file their respective proxy statements so they can clear the Staff's comments as soon as possible and start soliciting votes. Consistent with its rejection of the activist shareholder's nomination, the company's proxy card will only list the company's nominees[28] but, because the company expects the activist shareholder to file its own proxy statement, will include the Schedule 14A disclosures triggered by Rule 14a-12(c).[29]

In such a circumstance, the activist shareholder usually will not shy away from filing its own proxy statement while the lawsuit is pending. The activist shareholder will take the position that its nomination is valid and, hence, it will file a universal proxy card that lists both its own nominees and the target company's nominees and will similarly include the Rule 14a-12(c) disclosures.[30] In reviewing their proxy statements, the Staff will expect both parties to disclose what happens if the presiding court holds the activist shareholder's nomination notice to be valid. As explained in the Staff's Question 139.05 on proxy rules and Schedule 14A/14C, if "a court subsequently determines that the dissident shareholder's candidates are duly nominated, then the registrant is obligated under Rule 14a-19 to furnish universal proxy cards with the dissident shareholder's candidates."

Any votes received on the registrant's non-universal proxy card will be disregarded, and the registrant must ensure that shareholders are provided with sufficient time to vote on the universal proxy cards prior to the meeting. Companies would be well advised to use similar language as Question 139.05 to minimize the risk of receiving a comment. For example, based on our experience, limiting the need to adopt a new card to situations where a court issues a "final, non-appealable" order in favor of the activist shareholder's nomination notice could potentially result in a comment from the Staff questioning the basis for that narrow qualification.

Make Sure That the Treatment of Votes and Basis for Such Treatment Is Clearly Identified and Described in the Proxy Statement

Item 21 of Schedule 14A sets out requirements related to voting procedures. The Item requires, as to each matter to be voted on by shareholders, (a) a statement of the vote required for approval or election, and (b) the method by which votes are to be counted, including the treatment and effect of abstentions, broker non-votes and withholding of authority to vote for a director nominee.

The Staff's comments related to Item 21 of Schedule 14A have often focused on clarification of statements referring to the required vote or the treatment of abstentions and broker non-votes. To avoid these comments, when referencing the required vote for approving each proposal, check the applicable law and the applicable sections of the registrant's organizational documents to ensure the description is accurate.

For example, Section 312.07 of the New York Stock Exchange (NYSE) Listed Company Manual prescribes "a majority of the votes cast" standard for any shareholder approval but further provides that a company must calculate the votes cast in accordance with its governing documents and any applicable state law. This is different from the NYSE's historical position that abstentions are votes cast regardless of state law on that issue.

Further, ensure that the proxy statement clearly and consistently lays out the effects of abstentions and broker non-votes for each matter that will be submitted to a vote. The NYSE has special rules on its member organizations' discretionary voting power at a contested meeting. Under the NYSE's Rule 452, a member organization may vote without customer instructions only if the person in the member organization giving or authorizing the giving of the proxy has no knowledge of any contest as to the action to be taken at the meeting.

Accordingly, a registrant's proxy statement for a contested meeting may state that the intermediary organization will have discretionary authority to vote on a routine matter (e.g., ratification of auditors) without the beneficial owners' instructions if it does not receive any proxy material from the activist shareholder. Conversely, to the extent the activist shareholder does deliver proxy material to an intermediary, such intermediary will have no discretionary authority to vote on any matter at a contested meeting, including on the routine matters.

Review the Universal Proxy Rules and Ensure That the Proxy Statement and Accompanying Proxy Card Comply

Rule 14a-19 imposes a number of new requirements on registrants and activist shareholders and changes the landscape of contested proxy solicitations. Counsel should thoroughly review Rule 14a-19 and the other rules relating to the universal proxy card and implement the new requirements. As a gating item, Counsel should review the exceptions to Rule 14a-19, consisting of: (1) consent solicitations and (2) solicitations in connection with an election of directors at an investment company registered under the Investment Company Act of 1940, or a business development company as defined by Section 2(a)(48) of the Investment Company Act of 1940.

Previously, the Staff's comments related to proxy cards tended to focus on the requirements of Rule 14a-4 as to the form of proxy, separation between parties' proposals, the need to label a preliminary proxy card as such,[31] the proxyholders' discretionary voting power under Rule 14a-4(c) and formatting. The Staff has continued to make these comments from time to time, but it will be equally important to keep an eye out for comments specifically relating to Rule 14a-19. Since the adoption of the universal proxy rules, a small number of comments touching on the universal proxy rules have already been made public.

The following is a sample of those comments, all of which originated from Rule 14a-19(e):

- clearly distinguish the different groups of nominees and alphabetically order nominees by last name within such groups;
- use the same font type, style, and size for all nominees;
- prominently disclose the maximum number of nominees which can be voted for;
- prominently disclose the treatment and effect of a proxy that grants authority to vote for the

election of fewer or more nominees than the number of directors being elected; and
- prominently disclose the treatment and effect of a proxy executed in a manner that does not grant authority to vote with respect to any nominees.

We sometimes see a party's universal proxy card labelling the other party's nominees as nominees "opposed by" such party. So far, we have not seen the Staff objecting to such language. That is also consistent with the long-term practice of including recommendations "for" or "against" nominees on proxy cards.

Notes

1. Unless otherwise noted, all the rules cited in this article are under the Securities Exchange Act of 1934.
2. Rule 14a-5(c) states that "[a]ny information contained in any other proxy soliciting material which has been or will be furnished to each person solicited in connection with the same meeting or subject matter may be omitted from the proxy statement, if a clear reference is made to the particular document containing such information."
3. *See, e.g.*, comment letter dated February 28, 2022 on the PREC14A filed by Carl C. Icahn et al, available at *https://www.sec.gov/Archives/edgar/data/1692115/000000000022002247/filename1.pdf*.
4. Note D to Schedule 14A.
5. Preliminary proxy statement filed by Nathan Milikowsky et al on March 17, 2015, page 23, available at *https://www.sec.gov/Archives/edgar/data/931148/000119312515094560/d892047dprec14a.htm*.
6. Available at *https://www.sec.gov/Archives/edgar/data/931148/000000000015018086/filename1.pdf*.
7. *See, e.g.*, the Staff's comment letter dated February 11, 2021 on the PREC14A filed by Eminence Capital, LP et al, available at *https://www.sec.gov/Archives/edgar/data/1725579/000000000021001887/filename1.pdf*.
8. *Id.*
9. *See, e.g.*, the Staff's comment letter dated May 4, 2018 on the PREC14A filed by Alaska Communications Systems Group, Inc., available at *https://www.sec.gov/Archives/edgar/data/1089511/000000000018014060/filename1.pdf*.
10. *See, e.g.*, the Staff's comment letter dated April 30, 2018 on the PREC14A filed by Carl C. Icahn et al, available at *https://www.sec.gov/Archives/edgar/data/1349436/000000000018013389/filename1.pdf*.
11. *See, e.g.*, the Staff's comment letter dated June 9, 2014 on the PRRN14A filed by Casablanca Capital et al, available at *https://www.sec.gov/Archives/edgar/data/764065/000000000014029291/filename1.pdf*. Comment #2 notes that the filing persons implied that the registrant's directors breached their fiduciary duties. The comment asks the filing persons to either revise their statement to remove such implication or identify the implied breach and explain why the filing persons have not taken any legal action in response to such breach.
12. Comment letter dated September 7, 2021 on the PRRN14A filed by Sheldon Razin et al, available at *https://www.sec.gov/Archives/edgar/data/708818/000000000021010929/filename1.pdf*.
13. Comment letter dated November 29, 2021 on the PREC14A filed by Bradley L. Radoff et al, available at *https://www.sec.gov/Archives/edgar/data/316253/000000000021014334/filename1.pdf*.
14. Comment letter dated June 7, 2021 on the PREC14A filed by Lionbridge Capital I, LP et al, available at *https://www.sec.gov/Archives/edgar/data/908311/000000000021007183/filename1.pdf*.
15. *Id.*
16. Comment letter dated July 8, 2022 on the PREC14A filed by AB Value Partners LP et al, available at *https://www.sec.gov/Archives/edgar/data/1616262/000000000022007254/filename1.pdf*.
17. Comment letter dated March 11, 2022 on the PRER14A filed by DIRTT Environmental Solutions Ltd., available at *https://www.sec.gov/Archives/edgar/data/1340476/000000000022002734/filename1.pdf*.
18. *See, e.g.*, the Staff's comment letter dated April 12, 2021 on the PREC14A filed by Sonic Fund II, L.P. et al, available at *https://www.sec.gov/Archives/edgar/data/1501756/000000000021004603/filename1.pdf*.
19. *See, e.g.*, the Staff's comment letter dated May 24, 2019 on the PREC14A filed by Zvi Kurtzman et al, available at *https://www.sec.gov/Archives/edgar/data/826253/000000000019008974/filename1.pdf*.

20. As stated in Item 14, such actions consist of (i) a merger or consolidation, (ii) an acquisition of securities of another person, (iii) an acquisition of any other going business or the assets of a going business, (iv) a sale or other transfer of all or any substantial part of assets, and (v) a liquidation or dissolution.
21. Available at *https://www.sec.gov/Archives/edgar/data/897448/000000000023000850/filename1.pdf*.
22. Comment letter dated April 18, 2022 on the PREC14A filed by Mithrill II, LP et al, available at *https://www.sec.gov/Archives/edgar/data/1832038/000000000022004153/filename1.pdf*.
23. Comment letter dated June 16, 2022 on the PREC14A filed by the UpHealth Concerned Stockholders, available at *https://www.sec.gov/Archives/edgar/data/1770141/000000000022006575/filename1.pdf*. In describing settlement negotiations, be thoughtful about the level of detail to be included. It is crucial to bear in mind that the audiences of such disclosures are manifold: shareholders, proxy advisory firms, the parties to the contest, the parties' nominees, members of the incumbent board and management, the target company's D&O insurance provider, the presiding court (if a lawsuit is pending), and any other persons whose names turn up in these disclosures or who are otherwise interested in such disclosures.
24. *See, e.g.*, the Staff's comment letter dated April 19, 2022 on the PREC14A filed by The Donerail Group LP et al, available at *https://www.sec.gov/Archives/edgar/data/1493761/000000000022004201/filename1.pdf*. The activist shareholder's background section states that it emailed the company's CEO encouraging him "not to let his personal motivation get in the way of what was right for the Company's stockholders." The Staff's comment asked the activist shareholder to revise the entry to explain the reference to the CEO's "personal motivation."
25. Comment letter dated April 7, 2022 on the PREC14A filed by Ortelius Advisors, L.P. et al, available at *https://www.sec.gov/Archives/edgar/data/7039/000000000022003748/filename1.pdf*.
26. Comment letter dated March 18, 2022 on the PREC14A filed by COMRIT Investments I, LP et al, available at *https://www.sec.gov/Archives/edgar/data/1595527/000000000022003054/filename1.pdf*.
27. Comment letter dated February 28, 2022 on the PREC14A filed by Carl C. Icahn et al, available at *https://www.sec.gov/Archives/edgar/data/1692115/000000000022002247/filename1.pdf*.
28. The Staff's Question 139.04 on proxy rules and Schedules 14A/14C permits a registrant to omit the activist shareholder's nominees from its proxy statement if it determines that the activist shareholder's nomination does not comply with its advance notice bylaw requirements.
29. For an example of a proxy statement filed by a company in such circumstances, *see* the preliminary proxy statement filed by AIM ImmunoTech Inc. on September 9, 2022 with respect to its 2022 annual meeting, available at *https://www.sec.gov/Archives/edgar/data/946644/000149315222025508/formprec14a.htm*. As of the filing date, the company had rejected the nomination notice submitted by Jonathan Thomas Jorgl, who then filed a lawsuit challenging the company's decision. The case was pending when the company filed its preliminary proxy statement.
30. *See, e.g.*, the preliminary proxy statement filed by Mr. Jorgl on September 15, 2022 with respect to the 2022 annual meeting of AIM ImmunoTech Inc., available at *https://www.sec.gov/Archives/edgar/data/946644/000119312522245230/d329503dprec14a.htm*.
31. Rule 14a-6(e)(1) ("All copies of preliminary proxy statements and forms of proxy filed pursuant to [Rule 14a-6(a)] shall be clearly marked "Preliminary Copies," . . .").

BOOKS AND RECORDS

Delaware Court of Chancery Bars Stockholder from Inspecting Books and Records Related to Board's ESG-Related Decision

By Rick S. Horvath, Stephen M. Leitzell, Neil A. Steiner, and Christopher J. Merken

On June 27, 2023, the Delaware Court of Chancery issued a post-trial memorandum opinion in *Simeone v. The Walt Disney Company* rebuffing a stockholder attempt to inspect books and records of The Walt Disney Company (the Company) related to the Company's March 2022 response to Florida's "Parental Rights in Education" bill, sometimes referred to as the "Don't Say Gay" law (the Legislation).[1] Based in large part on the stockholder's own testimony, the Court held that the stockholder's "stated purposes" for the inspection demand were pretextual and improperly "lawyer-driven."[2]

The Court added that the stockholder failed to prove a credible basis to investigate wrongdoing related to the Company's "ordinary business decision" to comment on a matter of employee and public concern.[3] Alternatively, even if the stockholder had demonstrated a proper purpose, the Court held that three years of emails among and between the Company's Board of Directors and its CEO were not necessary for the stockholder's purpose because the Company had already produced policies and Board minutes and materials related to the Company's actions taken in March 2022.

Background

On March 7, 2022, 11 days after the Florida House of Representatives passed the Legislation, the Company's CEO circulated an internal memorandum to employees "expressing the company's 'unwavering commitment to the LGBTQ+ community[,]'" and explaining that although it had not publicly opposed the Legislation, the Company's "'lack of statement' should not be mistaken 'for a lack of support.'"[4]

The next day, March 8, the Florida Senate passed the Legislation and sent it to the governor for his signature. Also on March 8, the Board held a special meeting about the Company's "Political Engagement and Communications" and response to the Legislation. On March 9, at its annual stockholder meeting, the Company's CEO "acknowledged that 'many are upset that we did not speak out against the bill,'" and explained that the Company was "'opposed to the Legislation from the outset, but we chose not to take a public position on it because we thought we could be more effective working from behind the scenes, engaging directly with lawmakers on both sides of the aisle.'"[5]

Florida's governor signed the Legislation into law on March 28. Also on March 28, the Company issued a public statement opposing the law.[6] Florida's governor responded that the Company had "crossed the line."[7] The Company's public opposition to the Legislation prompted the Florida legislature to revoke the Company's "ability to self-govern its lands within the Reedy Creek Improvement District (RCID)," a unique legal structure which functionally gave the Company the ability to "levy taxes, write building codes, and develop and maintain its own infrastructure" within the district.[8]

Rick S. Horvath, Stephen M. Leitzell, Neil A. Steiner, *and* **Christopher J. Merken** *are attorneys of Dechert LLP.*

Although the Company's stock price fell from US$145.70 per share on March 1, 2022, to US$91.84 on July 14, 2022, the Court noted that the stockholder's only evidence related to the decline attributed it to factors other than the Company's opposition to the Legislation.

The stockholder's demand to inspect the Company's books and records followed. Pursuant to Section 220 of the Delaware General Corporation Law, a stockholder has a qualified right to inspect corporate books and records. To exercise that right, a stockholder must demonstrate a proper purpose as a stockholder for inspecting the corporate records, and that the records sought are essential for accomplishing the stockholder's stated purpose. Often such an inspection will be satisfied through the production of Board-level materials, with the burden on the stockholder to prove why additional, non-Board-level materials are necessary for resolving the demand.

According to his demand, the stockholder wanted to investigate potential misconduct because he was concerned the Company's officers and directors breached their fiduciary duties by "failing to appreciate the known risk that [the Company's] political stance would have on its financial position" and by "'placing their own political views ahead of their duties to act in the best interests of [the Company] and its stockholders.'"[9] While objecting that the stockholder failed to state a proper purpose for his inspection, in October 2022 the Company produced all formal Board documents concerning the Legislation as well as certain other documents.[10]

On December 5, 2022, the stockholder filed his verified complaint to compel further inspection of the Company's books and records. After holding a trial on a paper record, the Court rejected the stockholder's inspection demand.

The Court's Decision

The Stockholder's Stated Purposes Were Pretextual Because the Inspection Demand Was Impermissibly Lawyer-Driven

Because a stockholder must have a proper purpose as a stockholder for inspecting books and records, in "rare circumstances" the Court of Chancery has denied inspection demands when the demand was driven by the lawyers and not the demanding stockholder.[11] This case was one of those "rare circumstances." The Court determined that the Company showed the stockholder lacked a proper purpose for the inspection because the demand was impermissibly lawyer-driven, being intended to further the stockholder's lawyers' political agenda rather than any interest the plaintiff had as a stockholder of the Company.

The Court noted that the stockholder testified he had not considered pursuing litigation or making an inspection demand after learning about the Legislation. Rather, he was contacted by a lawyer who knew he was a stockholder of the Company and solicited him to make the demand. Another lawyer affiliated with the Thomas More Society, "a 'public interest law firm championing Life, Family, and Freedom,'" then met with the stockholder and the Society agreed to advance the stockholder's litigation costs.[12]

The stockholder further testified that "his only purpose for making the inspection" was to learn the identities of those responsible for the decision to publicly oppose the Legislation in the hopes those identities would become public. But the stockholder's written demand did not state these purposes—and even if they had been stated, the identities the stockholder sought to disclose were made public in this Section 220 litigation. Finally, the stockholder had "limited and non-substantive involvement in the demand and litigation," which the Court concluded "further reveal[ed] the lawyer-driven nature of this action."[13]

Accordingly, the Court held the stockholder lacked a proper purpose for the demand. The Court further noted that, although his counsel and the Thomas More Society (the driving force behind the demand) were entitled to their beliefs, and could prosecute litigation supporting those beliefs, a Section 220 suit to address plaintiff's interests as a stockholder is not the vehicle to advance those beliefs.

The Stockholder Failed to Show a Credible Basis to Investigate Wrongdoing

Even if his stated purpose to investigate wrongdoing was not pretextual, the Court held the stockholder failed to prove a credible basis to investigate wrongdoing.

Here, the Court concluded that the materials produced by the Company demonstrated the Board discussed the Company's response to the Legislation, including employee backlash about the Company's lack of comment on the Legislation and the Company's decision to speak publicly about the Legislation. Considering these facts, a decision to speak on public matters is within the power of the board "to direct the corporation's affairs."[14] Accordingly, the stockholder failed to present "any legitimate basis" to challenge the Board's impartiality—including because he testified that he had "no reason to believe any Board member" had "acted out of self-interest."[15]

The Court likewise rejected the stockholder's claim that the Board "'ignored a known risk' of negative consequences from opposing the [L]egislation."[16] The Court held that the stockholder failed to allege or present evidence that the Company "was warned of financial repercussions of the RCID *before [the CEO's] March 9 announcement*."[17] Instead, it was not until after the Company spoke on the Legislation that "the specter of dissolving the RCID was explicitly raised."[18]

As a result, the Court concluded the stockholder lacked a credible basis to investigate wrongdoing, and instead wanted to investigate a business decision with which he disagreed. But "disagreement with a business judgment" is not "'evidence of wrongdoing' warranting a Section 220 inspection" because it "would intrude upon the 'rights of directors to manage the business of the corporation without undue interference.'"[19]

The Stockholder Did Not Lack Essential Information

Finally, the Court concluded that even if the stockholder had demonstrated a proper purpose, "no further inspection would be warranted."[20]

The Company had produced "all Board-level materials related to the legislation, [the Company's] response to the legislation, the potential loss or modification of the RCID, and [the Company's] policies on charitable and political giving."[21] Despite that information, the stockholder demanded *three years* of email and other correspondence between and among the Board members and the Company's CEO on the same topics. Considering the Company's production, the Court concluded the stockholder's demand was "vastly overbroad"—and had no relation to investigating "one piece of legislation that was introduced and passed in 2022."[22]

Takeaways

The *Simeone* decision is a useful reminder that although rare, the right set of facts could defeat a Section 220 inspection demand as being lawyer—rather than stockholder—driven, particularly when the attorneys have a political or moral opposition related to the business issue. The facts in *Simeone* were particularly damning, and companies defending books and records litigation arising from ESG-related decisions should ensure they effectively probe a plaintiff's (often political or social) purposes in bringing the litigation.

Although we expect that many boards and their counsel will argue this decision supports the view that ESG-related Board decisions are a business judgment limiting what records a plaintiff can review or challenge, we believe this area of law will rapidly continue to develop. ESG-related decisions by boards of directors continue to draw investor scrutiny, and *important questions remain regarding the proper role of ESG in corporate governance.*

Accordingly, one can expect that attorneys experienced in books and records demands will develop a record likely to avoid the many defects reflected in the *Simeone* stockholder's litigation strategy. For these reasons, companies should continue to consider producing core board materials in response to Section 220 demands, even where they appear to be impermissibly lawyer-driven and notwithstanding the apparent absence of a stockholder's proper purpose, as an effective means to defend against any litigation that a stockholder may file seeking emails and other materials beyond formal board materials.

Notes

1. Simeone v. The Walt Disney Company, No. 2022-1120-LWW, at 3 (Del. Ch. June 27, 2023).
2. *Id*. at 19–21.
3. *Id*. at 25.
4. *Id*.
5. *Id*. at 6.
6. *Id*.
7. *Id*.
8. *Id*. at 9.
9. *Id*. at 11–12.
10. *Id*.
11. *Id*. at 19 (citation omitted).
12. *Id*. at 20.
13. *Id*. at 21. Indeed, the Court held that "the only evidence indicating that the purposes listed in the demand might belong to [the stockholder] is the testimony his counsel elicited through leading redirect questions"—testimony that the Court gave no weight. *Id*. 21 & n.108.
14. *Id*. at 25.
15. *Id*. at 28–29 & n.143.
16. *Id*. at 29.
17. *Id*. at 30 (emphasis added).
18. *Id*.
19. *Id*. (citation omitted).
20. *Id*. at 31.
21. *Id*. at 32.
22. *Id*. at 33.

ESG

Global Sustainability Standards Takeoff; While the SEC's Climate Disclosure Rules Remain on the Tarmac

By Mark S. Bergman

On Monday, following 18 months of work, the International Sustainability Standards Board (ISSB) formally issued its inaugural corporate disclosure standards: IFRS S1 (General Requirements for Disclosure of Sustainability-Related Financial Information), and IFRS S2 (Climate-Related Disclosures) (collectively, the Standards).[1] The Standards respond to longstanding demands from investors and other stakeholders for consistent, comprehensive and comparable, decision-useful information to enable them to gain an understanding of a company's performance and prospects from a sustainability standpoint.

In the words of the ISSB, these Standards establish a global baseline for sustainability disclosure—a common language for disclosing the effects of climate-related risks and opportunities on a company's "prospects." Ultimately, the Standards are designed to provide users of corporate financial reporting with information relevant to investment decisions in the subject reporting companies.[2]

The ISSB did not set out to, and in fact did not, reinvent the wheel. The Standards build upon preexisting voluntary disclosure frameworks, such as the industry-specific Sustainability Accounting Standards Board (SASB) standards, and "fully incorporate" the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations.[3] IFRS S1 and IFRS S2 are geared towards investors and the markets, rather than the broader stakeholder landscape, covered, for example, by the Global Reporting Initiative (GRI) standards.

The Standards have been developed in parallel with the EU corporate disclosure standards, and are intended to be "interoperable" with the EU standards (note that the Corporate Sustainability Reporting Directive, for example, is broader as it is geared to a broader universe of stakeholders),[4] and a Memorandum of Understanding with the GRI is intended to ensure that the ISSB, in the words of its Chair, Emmanuel Faber, "can provide a comprehensive and seamless suite of reporting standards."[5]

As was the case for International Financial Reporting Standards (IFRS), the IFRS Foundation does not have the authority to establish mandatory requirements. Jurisdictions, however, will be free to make the Standards mandatory, and to impose more stringent requirements if they wish to do so. Disclosure may be provided under the Standards regardless of whether the reporting company presents its financial statements in accordance with IFRS or other financial reporting standards (such as, GAAP).

The Standards are effective for reporting periods beginning on or after January 1, 2024. Earlier adoption is permitted provided both Standards are applied. The issuance of IFRS S2 reflects the decision of the ISSB to focus first on climate-related risks (that is, physical risks and transition risks) and opportunities, rather than on the broader sustainability landscape. Broader sustainability disclosure would be provided in the second year of reporting.

In its Monday press release, the ISSB announced that it will now work with jurisdictions and companies

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to support adoption and, as a first step in that effort, is establishing a Transition Implementation Group to support companies that apply the Standards. The ISSB also announced that it will continue to work with jurisdictions wishing to require incremental disclosure standards that are more stringent than the ISSB baseline and will work with the GRI to support efficient and effective reporting when the Standards are used in combination with other reporting standards, for example, those prepared by the European Commission or the Securities and Exchange Commission (SEC).

Disclosure Requirements

In short, IFRS S1 requires reporting companies to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect their cash flows and their access to finance or cost of capital over the short, medium or long term (collectively referred to as "sustainability-related risks and opportunities that could reasonably be expected to affect the reporting company's prospects"). IFRS S1 prescribes how sustainability-related financial disclosures are to be prepared and presented, and sets out general requirements for the content and presentation of those disclosures.

The disclosure requirements essentially have four pillars:

1. Governance processes, controls and procedures used to monitor, manage and oversee sustainability-related risks and opportunities;
2. Strategy for managing sustainability-related risks and opportunities;
3. Processes used to identify, assess, prioritize and monitor sustainability-related risks and opportunities; and
4. Performance in relation to sustainability-related risks and opportunities, including progress towards any targets the reporting company has set or is required to meet by law or regulation.

IFRS S2 adopts the same general framework around governance, strategy, risk management, and metrics and targets, but then takes a deep dive setting forth detailed requirements for climate-related risks and opportunities. IFRS S2 also provides sector guidance based on the SASB Sustainable Industry Classification System: consumer goods; extractive and mineral processing; financial services; food and beverage; healthcare; infrastructure; renewables; resource transformation; services; technology and communications; and transportation—each with their own subsections (68 in total). The ISSB has also provided illustrative examples, illustrative guidance and industry-based guidance.

There is transitional relief under IFRS S2, permitting delay of one reporting cycle for comparative information for the period prior to application, and for reporting companies that measure their Greenhouse Gas (GHG) emissions other than in accordance with the 2004 Greenhouse Gas Protocol (that other standard may be used during the first year) and for reporting companies involved in asset management, commercial banking or insurance activities, which can skip for one year Scope 3 disclosures about financed emissions.

The Scope 3 disclosure standards illustrate the collaborative nature of the ISSB endeavor. ISSB Chair Faber notes that investor feedback (reflected in over 1,400 comment letters) made clear that Scope 3 disclosure is important, particularly to assess transition in portfolio companies, and confirmed for the ISSB the imperative of including Scope 3 requirements.[6] The feedback also highlighted the challenges reporting companies would face, particularly in respect of mapping the full value chain or supply chain. The one-year delay, proportionality measures and guidance for Scope 3 are intended to mitigate this burden.

Investor feedback also prompted the adoption of the same definition of "materiality" as is used in IFRS, in light of the connection between accounting and sustainability disclosures. More broadly, scalability and proportionality, via structural and transitional relief, reflect an awareness of the breadth of reporting companies in capital markets portfolios, in terms of size as well as phase of development.

Concluding Thoughts

The ISSB has been crystal clear in its mission. It is responding to a robustly articulated demand for a global baseline that is seen by the markets as urgent and necessary. Next steps include obtaining the endorsement of the International Organization of Securities Commissions (IOSCO), to facilitate engagement with national and regional regulators.

The ISSB also will be finalizing a digital taxonomy to enhance cost effectiveness and interoperability. Longer term, the ISSB will be rolling out sustainability standards for biodiversity, ecosystems and ecosystem services; human capital; and human rights, and will also be considering how best to integrate information in financial reporting beyond the relationship embedded in IFRS S1 and IFRS S2.

What is both heartening and disheartening of where we are today in the evolution of climate- and broader ESG-related disclosure standards is that while global standard setters are moving with alacrity in responding to the needs of investors and the markets, there is a growing anti-ESG movement in the United States, largely driven by the weaponization of culture wars for political gain, supported by an opaque campaign finance ecosystem that benefits well-funded vested interests. Stakeholder feedback underscores the imperative of overcoming resistance and embracing the global effort.

Assuming the SEC climate-related disclosure requirements do take flight, they are likely to be less onerous than the ISSB Standards. In light of the strong desire for a single global standard, the ISSB Standards may well become the global default even if adoption means providing more granular disclosure.

Notes

1. *https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/.*
2. *https://www.7pillarsglobal-insights.com/_files/ugd/24200f_7cf93b18d6f94ccda2b6fae7175a827f.pdf.*
3. *https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf.*
4. *https://www.7pillarsglobal-insights.com/_files/ugd/24200f_ea43c556783b42c09d24f41211ecf309.pdf.*
5. *https://www.greenbiz.com/article/first-issb-reporting-standards-are-here-what-means-investors.*
6. *https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/feedback-statement.pdf..*

ESGAUGE, the Resource for ESG Practices: an Interview

By Paul Hodgson

Recently I sat down with Paul Hodgson, Senior Advisor in the United States for ESGAUGE, a data mining and analytics firm designed for corporate practitioners and professional service firms seeking customized information on US public companies, and conducted this interview.

Broc: What is the essence of ESGAUGE?

Paul: It focuses on the disclosure of environmental, social, and governance (ESG) practices such as executive and director compensation, board practices, CEO and NEO profiles, succession planning, proxy voting and shareholder activism, and CSR/sustainability disclosure.

It has an advanced AI function, as well as a team of human quality control staff which pull in complex data—text and table-based—from a variety of sources, though mostly public filings at the Securities and Exchange Commission.

Broc: What made you, with all your history of data collection and analysis, want to work for ESGAUGE?

Paul: Like you imply, I've been working in data collection for well over 30 years. First, I was doing the data collection myself and then I was training staff to do it and just doing the analysis. I've seen countless companies offering data from data mining tools and never been particularly impressed with their accuracy.

But ESGAUGE has this function where, in all its benchmarking tools, you can click on the datapoint and be taken to the filing, the line in the filing, or the line in the table which is where that particular datapoint came from. So, you can be looking at something that says some CEO gets a $12 million base salary, and you say, oh, come on, that can't be true, no one gets paid that much in salary, but you can click on that datapoint in the benchmarking tool and, lo and behold, there it is in the Summary Compensation Table.

It's like that for every database they have, so you can be looking at what percentage of racial or ethnic minorities are in a particular company's workforce and 'click,' there you are in the 2022 ESG/sustainability report or wherever. I figured that anyone that confident with their data would be worth working for.

Broc: So, what are the datasets that ESGAUGE offers?

Paul: There are eight databases: executive compensation, director compensation, board practices, CEO profiles, CEO succession, shareholder voting, environmental and HCM [human capital management] + social.

And then, even within those, there are countless sub-databases, all the way from ESG incentive plan metrics, to COVID-19 compensation changes, to board committee ESG responsibilities, board diversity surveys, Pre-IPO [initial public offering] screening and IPO compensation data. And new data sets keep getting added.

Broc: ESG is the abbreviation of the moment, tell me about the environmental and HCM + social data that you are collecting?

Paul: So, for example, in the environmental screening tool, you can search by subject—everything from GHG [greenhouse gas] emissions or reduction targets to water consumption, waste reduction, number of related fines, energy consumption, basically a company's whole environmental footprint.

You can narrow these searches down to very specific topics, and you can search by datasource—which

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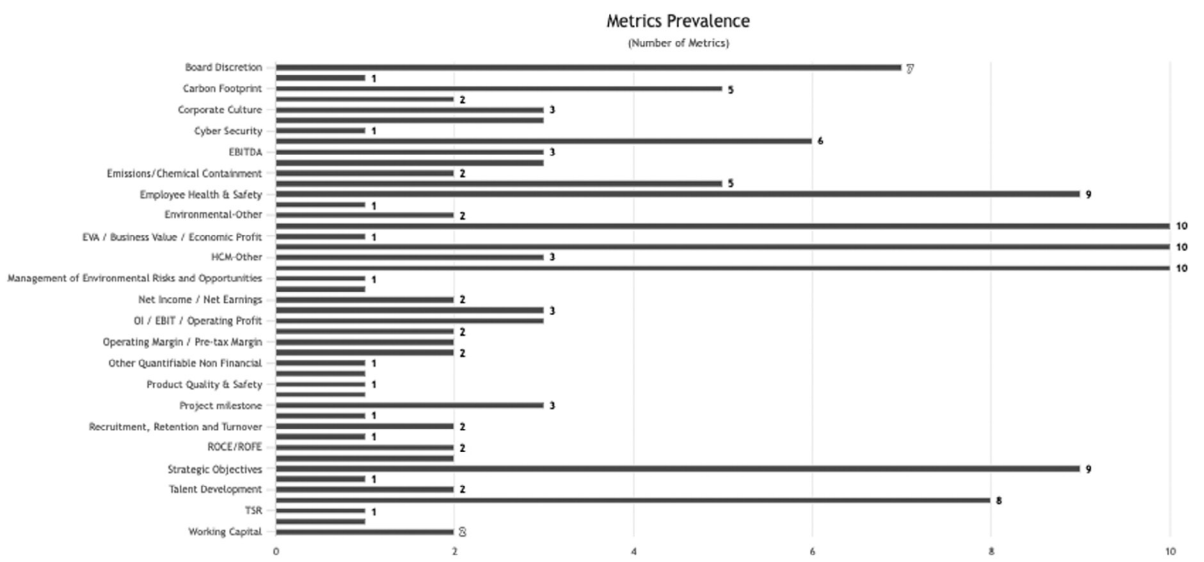

company document the data is found in—and by corporate profile or peer group. You can also screen by reporting standard, which at the moment comprises GRI [Global Reporting Initiative] and SASB [Sustainability Accounting Standards Board], but will include the SEC [Securities and Exchange Commission] disclosure standards when it finally gets round to introducing them.

It's the same structure for HCM + social, except with a whole set of different topics on everything from charitable and political donations to DE&I initiatives, right down to adherence to TCFD [Task Force on Climate-related Financial Disclosures] recommendations, UN SDGs [sustainable development goals], whistleblower policies, all sorts of supply chain issues, pay gaps, women in management. As with the E, a complete S footprint.

Broc: Can you talk about your partnership with "The Conference Board"?

Paul: Sure, that's how I got involved, actually, as I was writing the Conference Board's long reports on everything from exec pay to director pay to board practices. TCB had had to give up its reports on board practices as it wasn't getting enough data from its surveys, but then along came ESGAUGE with a full dataset for the whole Russell 3000, I mean, everything from exclusive forums to director onboarding, to director elections and removals, to board composition. I don't even know what an exclusive forum is! Well, I didn't, but I had to look it up. It's mind boggling, the amount of data.

You can see dashboard visualizations on the TCB ESGUAGE website for free. Of course, it is just a fraction of the data that we actually collect but it is a good first look at the richness and depth and granularity of it all. (*See* Chart below.)

Broc: What's your favorite out of all the benchmarking/screening tools?

Paul: I'd have to go back to my 'first love,' executive compensation. The detail is impressive, it's what I would have loved to do at my old firm The Corporate Library, but we couldn't hire enough staff. Just the detail on the performance metrics is incredible.

And those are just an example, in this case of the metrics used for annual bonuses for Ford's pay peer group. But there's CEO pay ratios, equity dilution and more.

Broc: Does ESGAUGE conduct bespoke data surveys for clients?

Paul: Of course, that's how a lot of these sub-databases came about. We have a number of clients who have a certain number of bespoke data collections written into their contracts, that we take care of in the off-proxy season.

Broc: And what about custom designs for clients, so they can see the data in exactly the way they want?

Paul: Regularly. I think every client I work with has asked for the data visualization and representation to be adapted to their way of seeing. It's just a great team in New Delhi that can take on these tasks very readily.

EXECUTIVE PAY

Decisions, Decisions: The SEC's Clawback Rules Call for Lots of Them

By Bob Lamm

In October 2022, the Securities and Exchange Commission (SEC) adopted final rules regarding the "recovery of erroneously awarded compensation," or "clawbacks," consistent with the requirements of the Dodd-Frank Act.[1] The new rules direct the national securities exchanges to establish listing standards requiring companies to adopt, enforce, and disclose policies implementing the rules. It currently appears that listed companies will be required to adopt compliant clawback policies by December 1, 2023.

The new rules are complex and require a listed company to take a number of steps in order to amend existing clawback policies or provisions (contained in compensation plans or otherwise) or, if none, to adopt and implement one or more compliant policies in a timely manner. The following is a summary of the key steps to be taken and decisions to be made.

- If your company has an existing clawback policy, you will need to compare the existing policy to the requirements of the new rules, including any additional requirements in the applicable listing standards. For example:
    - — Existing policies may apply to a narrower or broader employee population than is required under the new rules, which applies to current and former Section 16 officers.
    - — Existing policies may be tied to a specific type of restatement or may apply only in cases of misconduct. The new rules require recoupment for two types of restatements and apply whether or not the restatements are the result of misconduct.
    - — Existing policies may apply to different forms of compensation. The new rules apply to all "incentive-based compensation," which is broadly defined as any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any "financial reporting measure."
    - — Existing policies may be discretionary, whereas under the new rules, clawbacks are mandatory except in three limited circumstances.
- You may need to consider whether to maintain one clawback policy that complies with the new rules, or to maintain multiple policies, some of which may apply to a different subset of employees or provide for different circumstances for recoupment. Some key considerations are as follows:
    - — Multiple policies will afford the company greater discretion in determining whether and under what circumstances to recover compensation from non-executive officers.
    - — Multiple policies will enable the company to maintain the confidentiality of any policy that applies to individuals other than executive officers.
    - — A separate discretionary clawback policy that is triggered by material misconduct, a violation of company's code of conduct, or other types of misconduct

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    may serve to help resolve criminal investigations.
  - However, multiple policies may create administrative and other challenges, such as uncertainty on the part of both the company and its executives as to which policy applies in certain circumstances.
- If your company has any existing clawback provisions, including provisions in plans, specific grants under plans, employment agreements, or otherwise, you will need to consider how to treat them vis-à-vis the new rules. Some key considerations are as follows:
  - You may want to retain the existing provisions. However, this may entail changing the provisions so that they do not conflict or are not inconsistent with the new rules.
    - i. As is the case with multiple policies, having provisions that are inconsistent with the policy may create administrative and other challenges, such as uncertainty on the part of both the company and its executives as to which policy or provision applies in certain circumstances.
    - ii. Another possibility is to specify that the SEC-compliant policy overrides conflicting provisions in other documents/agreements. However, such language may not be enforceable.
    - iii. Note that the company may not be able to change provisions without the consent of the executive(s) in question.
  - You may determine to eliminate the provisions to avoid conflicts or inconsistencies, subject to obtaining any necessary consents.
- You need to determine whether the Compensation Committee or the Board will enforce the policy and how they will do so. Note that the SEC rules do not specify how a company must enforce its policies.
- When reviewing existing incentive compensation plans and agreements, you should:
  - Consider whether to adjust performance metrics or the mix of incentive and non-incentive-based compensation to better fit the clawback policy requirements.
  - Consider imposing mandatory deferrals or holding requirements on earned incentive awards to facilitate implementation of the clawback policy.
  - Consider having executive officers acknowledge changes to the policy that may affect previously issued awards.
- When entering into new compensation arrangements, you should check that they are consistent with the clawback policy and, where applicable, include the necessary contractual links to the enforcement of the policy.
- Companies need to review executive officer determinations and ensure proper classification.
  - As all Section 16 officers and any other persons identified as executive officers in the company's proxy statement or 10-K will now be subject to the clawback policy, companies should review their executive officer determinations to make sure that all individuals are properly classified.
  - The determinations should be updated at least annually. The annual election of officers following each annual meeting of the board (usually held at the time of the annual meeting of shareholders) is an opportune time to make these determinations, and determinations as to which officers are "executive officers" can be reflected in the minutes of the board meeting.
- Companies will need to make the required disclosures of their SEC-compliant policies.

- — The clawback policy must be filed as an exhibit to the annual report on Form 10-K, Form 20-F, or Form 40-F.
- — Additional disclosures may be required under certain circumstances, including:
    i. Disclosure in proxy and information statements if, at any time during or after the company's last completed fiscal year, the company either (a) was required to prepare an accounting restatement that required a clawback under the company's clawback policy or (b) there was an outstanding balance of unrecovered excess incentivebased compensation relating to a prior restatement.
    ii. If at any time during or after its last completed fiscal year a company was required to prepare an accounting restatement and concluded that recovery of erroneously awarded compensation was not required pursuant to the company's clawback policy, the company must briefly explain why application of its clawback policy resulted in this conclusion.
    iii. If recovered amounts reduce amounts previously reported in the Summary Compensation Table, the amount must be deducted from the applicable column and total column for the year in which the recovered amount was originally reported, and this amount must be identified in a footnote to the table.

Note

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1. A summary of the rules can be found at *https://gunster.com/alerts/easy-come-easy-go-the-sec-finally-adopts-clawback-rules/, and a more complete description has been posted at https://www.thesecuritiesedge.com/.*

AUDITORS

New Sheriff in Town? The PCAOB's "Noncompliance with Laws and Regulations" Proposal

By Allison Handy and Ben Dale

On June 6, 2023, the Public Company Accounting Oversight Board (PCAOB) issued a proposal for public comment[1] to replace current AS 2405 (Illegal Acts by Clients), in its entirety with a new AS 2405 (A Company's Noncompliance with Laws and Regulations).[2] If adopted, the proposal would strengthen auditor requirements to identify, evaluate, and communicate possible or actual noncompliance with laws and regulations. The comment period is open through August 7, 2023. Here are five things to know.

1. New Requirement to Identify

The proposal would require auditors to proactively identify—through inquiry and additional procedures—laws and regulations that are applicable to the company and that *could* have a *material effect* on the financial statements, if not complied with.

This new requirement represents a significant change from the current standard that requires an auditor to obtain reasonable assurance that financial statements are free of material misstatements from illegal acts that *would* have a *direct* and *material effect* on financial statements. The current standard also calls for auditors to make more limited inquiries, and obtain written representations, concerning other violations or possible violations of law that have only an indirect effect on financial statements.

Allison Handy *and* **Ben Dale** *are attorneys of Perkins Coie LLP.*

2. New Requirement to Evaluate

The proposal would require auditors to evaluate whether noncompliance with the identified laws and regulations has occurred, and if so, the possible effects on the financial statements and other aspects of the audit. The extent of audit procedures for this evaluation may be quite significant, including engaging legal counsel or other specialists to assist the auditor in the process of understanding the nature of potential noncompliance and determining whether it is likely that noncompliance occurred.

If likely noncompliance is identified, the auditor would be required to determine the possible effect on the financial statements and assess the implications on other aspects of the audit. In addition, the proposed standard would require an auditor to determine whether senior management has taken timely and appropriate remedial action to address the noncompliance.

3. New Requirement to Communicate

The proposal would require auditors to communicate to the appropriate level of management and the audit committee: (i) as soon as they are made aware that noncompliance with laws or regulations has or may have occurred; and (ii) the results of the auditor's evaluation of such noncompliance. Currently, the standard only requires the auditor to communicate illegal acts to the audit committee when it comes to the auditor's attention as practicable and before issuing the auditor's report.

4. Significant Expansion of the Role of the Auditor

Two PCAOB Board members dissented from the rule proposal. Board Members DesParte and Ho, who are the only two Board Members who are CPAs, each issued a statement explaining their dissent. Among other concerns, both focused on the proposal's significant expansion of auditor responsibilities and the substantial costs associated with this expansion. This concern is likely one shared by many public companies. Board Member Ho summarized her concerns:

> Unfortunately, the proposed standards before the Board today contain a breathtaking expansion of the auditors' responsibilities, which I believe will hurt investors. This expansion could cause considerable confusion on the appropriate role of auditors, undermine the time-tested accountability framework, and reduce the resilience of the already highly concentrated audit marketplace.

Board Member DesParte echoed these concerns, noting that the extensive new procedures "will require legal acumen and expertise well beyond the auditor's core competency."

5. Attorney-Client Privilege

Another area of concern for lawyers considering the rule proposal is the potential increased risk to maintaining attorney-client and work product privileges over materials related to internal company investigations. Privilege questions arise frequently in connection with internal investigations and related communications to the company's auditor. Many companies and their counsel take careful and deliberate steps in deciding what information, and how, to share with auditors regarding internal investigations to ensure auditors obtain appropriate information while protecting the company's attorney-client privilege.

The proposal has the potential to create new and increased risks of waiving privilege in these circumstances. In particular, the new evaluation requirement for the auditor would likely create increased pressure from auditors to provide even more information about the underlying investigation as opposed to a higher-level overview of the process, scope, and facts identified in an internal investigation.

Notes

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1. Release No. 2023-003.
2. *https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/pcaob-release-no.-2023-003---noclar.pdf*.

ARTIFICIAL INTELLIGENCE

The Surprising Impact of Generative AI on Transactional Lawyer Practices

By Arian Galavis

With the apparent speed at which ChatGPT and other generative artificial intelligence (AI) models are being adopted—the ChatGPT website is logging an estimated 1 billion visitors monthly. It seems inevitable that transactional attorneys will not only need to familiarize themselves with generative AI technology, but actively seek ways to incorporate this technology into their practices in order to remain competitive.

With this in mind, I spent a little time working through ways it could meaningfully support my M&A and Emerging Companies/Venture Capital practice. As expected, I was able to use the free version of ChatGPT to help summarize important legal concepts. For example, it was able to accurately summarize (at a high level) how fraud and nonreliance concepts might be addressed in a merger agreement and synthesize the interplay between those concepts. Here is what that looked like:

Me: Can you explain the interplay between fraud and nonreliance in merger agreements?

ChatGPT: *Sure, I can explain the interplay between fraud and nonreliance in merger agreements.*

Fraud and nonreliance are two related but distinct concepts that often come up in the context of merger agreements. Fraud occurs when one party intentionally makes a false statement or misrepresentation that the other party relies on to its detriment. In the context of a merger agreement, fraud can occur when one party makes a false statement or misrepresentation about the target company's financials, operations, or other material facts.

Nonreliance, on the other hand, is a contractual provision in which the parties agree that they are not relying on any statements or representations made by the other party except as expressly set forth in the merger agreement. This provision is intended to limit one party's ability to claim that it was misled or defrauded by the other party's statements outside of the merger agreement.

The interplay between fraud and nonreliance in merger agreements can be complex. On the one hand, nonreliance provisions can limit a buyer's ability to claim that it was defrauded by the seller's statements outside of the merger agreement. On the other hand, nonreliance provisions do not limit a buyer's ability to claim that the seller made fraudulent statements or misrepresentations within the four corners of the merger agreement itself.

Thus, if a buyer discovers that the seller made a fraudulent misrepresentation about the target company's financials or operations within the merger agreement, the nonreliance provision would not necessarily prevent the buyer from bringing a fraud claim against the seller. However, if the fraudulent misrepresentation was made outside of the merger agreement, the nonreliance provision could limit the buyer's ability to recover damages for the fraud.

In short, fraud and nonreliance are two important concepts that must be carefully considered and balanced in the drafting of a merger agreement.

What was more unexpected was its facility in contract drafting, and I figured I would test out the model on one of the more heavily negotiated provisions in M&A agreements: indemnification. For this, I pulled a generic indemnification provision from the Internet and created a seller-favorable version and a buyer-favorable version. After about 5-10 minutes of asking the model various questions, it was able to

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identify which version was buyer-favorable or seller-favorable, and how each version shifted risk to the applicable counterparty.

Here's an example of the back-and-forth.

Me: Could you please compare these two provisions and let me know which is more buyer-favorable?

Here is the first:

Indemnification by the Seller. The Seller agrees to and will defend and indemnify the Buyer Parties and save and hold each of them harmless against, and pay on behalf of or reimburse such Buyer Parties for, any Losses which any such Buyer Party may suffer, sustain or become subject to, as a result of, in connection with, relating or incidental to or arising from:

1. Any breach by the Seller of any representation or warranty made by the Seller in this Agreement or any closing certificate;
2. Any breach of any covenant or agreement by the Seller under this Agreement or any Additional Closing Document;
3. Any of the matters set forth on Schedule [___];
4. Any Company Indebtedness or Company Expenses to the extent not repaid or paid, respectively, pursuant to Section [___] and not included in the purchase price adjustment pursuant to Section [___].

Here is the second:

Indemnification by the Seller. The Seller agrees to and will defend and indemnify the Buyer Parties and save and hold each of them harmless against, and pay on behalf of or reimburse such Buyer Parties for, any Losses which any such Buyer Party may suffer, sustain or become subject to, as a result of, in connection with, relating or incidental to or arising from:

1. Any breach by the Seller of any representation or warranty made by the Seller in this Agreement or any Additional Closing Document;
2. Any breach of any covenant or agreement by the Seller under this Agreement or any Additional Closing Document;
3. Any of the matters set forth on Schedule [___];
4. Any Taxes due or payable by the Company or its Affiliates with respect to any Pre-Closing Tax Periods; or
5. Any Company Indebtedness or Company Expenses to the extent not repaid or paid, respectively, pursuant to Section [___] and not included in the purchase price adjustment pursuant to Section [___].

ChatGPT: *Based on a comparison of the two provisions, the first provision appears to be more buyer-favorable compared to the second provision. This is because the first provision requires the seller to indemnify the buyer for any Losses "in connection with, relating or incidental to or arising from" a broader range of matters, including breaches of representations or warranties made in any closing certificate, and breaches of covenants or agreements under any Additional Closing Document. This expands the scope of the seller's indemnification obligations and increases the potential for the buyer to recover losses. In contrast, the second provision limits the seller's indemnification obligations to specific matters listed, which is more seller-favorable.*

Me: If you review again, you'll see that both limit to specific instances, but the first provision includes a shorter list of items (1–4) while the second provision includes a longer list of items (1–5). With this additional information, can you please let me know which is more buyer-favorable?

ChatGPT: *Thank you for pointing that out. With the additional information, it seems that the second provision is more buyer-favorable, as it includes a longer list of items for which the seller has indemnification obligations. The inclusion of item (v) in the second provision, which addresses the non-payment or non-repayment of Company Indebtedness or Company Expenses not included in the purchase price adjustment, further expands the seller's indemnification obligations. This gives the buyer more protection and reduces the buyer's risk of financial loss.*

As you'll see, the model isn't infallible. And in fact, its first response was incorrect. However, with one additional piece of information, it not only identified which provision was buyer-favorable but synthesized why it was buyer-favorable.

A particularly powerful aspect of this technology in a transaction practice is the fact that a practitioner can use plain language to direct it to draft a particular flavor of provision on the spot (instead of spending time searching for several examples, selecting which one is most appropriate, modifying the provision to apply to the specific transaction and then incorporating it into a draft agreement).

Suddenly, directives such as, "please update this provision to limit seller's liability only to fraud" are feasible.

Here's an example of how one might prompt ChatGPT to do that:

Me: Could you please provide a seller-favorable indemnification provision that limits seller's liability only to fraud?

ChatGPT: *Sure, here's an example of a seller-favorable indemnification provision that limits seller's liability only to fraud:*

"Indemnification by the Seller. The Seller shall indemnify, defend, and hold harmless the Buyer and its affiliates, officers, directors, employees, and agents (collectively, the Buyer Indemnitees) from and against any and all losses, claims, damages, liabilities, costs, and expenses (including reasonable attorney fees and costs) suffered or incurred by the Buyer Indemnitees arising out of or relating to any fraud committed by the Seller prior to or in connection with the execution and delivery of this Agreement."

This provision limits the seller's indemnification obligations to losses arising out of or relating to fraud committed by the seller. This means that the buyer would not be able to seek indemnification from the seller for any other losses, such as breaches of representations and warranties or covenants, except for those resulting from fraud.

Again, as you'll see, the response isn't perfect—and the request somewhat simplistic—but the model does appear to have such general capability.

There are a few important caveats worth mentioning. First, one clearly needs to be an experienced practitioner to identify when the model is going off course or is providing a "close, but not quite correct" or fictitious response. As ChatGPT aptly pointed out to me, "*While AI algorithms can be trained to recognize and generate legal language, they may not always understand the context in which the language is being used. This could lead to mistakes or inaccuracies in legal documents that could have serious legal consequences.*"

There has been recent press about lawyers relying on ChatGPT-created case precedents in court filings that turned out to be fictional, further supporting that practitioners need to actively scrutinize the information that ChatGPT is conveying. Second, the model underlying ChatGPT is only trained through middle to late 2021, so it is not suitable for questions where the law or legal practice has changed recently or frequently.

Third, my inquiries were purely hypothetical in nature and did not involve any client information, but as these tools continue to develop and become integrated into actual practice, lawyers need to consider the ethical ramifications of using these tools, especially those that have not been specifically designed to provide a secure environment.

My key takeaway from all of this is that generative AI platforms already have the ability, in certain circumstances, to make practitioners more efficient. As the sophistication and variety of generative AI tools expand, so too will the potential benefits to practitioners and their clients.

However, we should be aware of its limits and consider other consequences it may have. For example, we may need to examine best training practices for junior practitioners to ensure that they are learning the substance needed to supervise and maximize the value of generative AI technology. And if you're wondering, yes, I used ChatGPT to help prepare an initial draft of this article.

EARNINGS

Earnings Pre-Release Considerations

By Paul Choi, Jim Ducayet, Beth Berg, and Helen Jazzar

When deciding whether to pre-release earnings, companies should assess the implications of pre-releasing from both a practical and legal perspective. Although not required by the US Securities and Exchange Commission (SEC) rules or stock exchange listing standards, publicly traded companies typically issue earnings press releases and hold earnings calls with investors and analysts each quarter to satisfy market demand for financial information shortly before filing periodic SEC reports on Form 10-Q and Form 10-K.

Some companies limit the content of the quarterly earnings release and earnings call to historical financial results, while others choose to provide earnings guidance or projections. In this article, for convenience of reference, "guidance" or "projections" refers to forward-looking financial information regarding a company's expected future financial or operating results.

Companies may choose to "pre-release" or "pre-announce" expected quarterly financial results prior to a regularly scheduled earnings release even though they are typically not legally required to do so. Pre-releasing earnings is a form of voluntary disclosure typically used in situations where a company anticipates earnings to differ materially from the expectations of investors or analysts or from guidance the company previously issued.[1]

A number of considerations to take into account when deciding whether to pre-release earnings are discussed.

Whether a Pre-Release Is Legally Required

Absent unusual circumstances, a company is under no obligation to update guidance or projections in "real time," and the caselaw on whether there is a duty to correct guidance or projections (as opposed to historical information) is murky at best. As a general rule, however, any duty to disclose information prior to a periodic SEC filing is likely to depend on whether the information to be updated lacked a subjective good faith basis or was objectively unreasonable. The greater the difference between actual results and those contemplated by the guidance or projections—and the shorter the timeframe between the last public statement of the guidance or projection and when the company determines that it will miss such guidance or projection—the more likely it is that a plaintiff or a regulator will argue that the guidance or projection was incorrect when made and that there was therefore a duty to correct.

Credibility with Investors and Analysts

Investors and analysts do not want to be blindsided. Even though earnings releases include disclaimers explaining that projections are subject to potential risks that could cause actual results to differ materially from those projected at the time, a significant miss may nevertheless undermine hard-won credibility. A pre-release may avoid some of this

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credibility hit by showing investors that the company is being transparent with them and ensuring that they are apprised of significant adverse developments even before the company would otherwise be required to disclose them.

Confidence in the Accuracy of the Pre-Release

If a company has determined to pre-release its results, it should do so only when management is highly confident in the accuracy of the numbers, or at least a relatively narrow range. Having to make more than one pre-release, or ultimately reporting final financial results that materially differ from those reported in the pre-release, may backfire and end up harming rather than helping the company's credibility with investors and analysts. When preparing the pre-release, companies should ensure that no material information is omitted that might render the disclosure materially misleading or inaccurate.

Litigation and Risk Management

Although difficult (if not impossible) to test empirically, many believe that a pre-release may reduce market reaction to negative developments when compared to waiting until the company's normal periodic disclosure. Whether or not that is true, there is at least some benefit to a pre-release because it will reduce the size of the potential class of plaintiffs that can bring litigation in connection with any stock price decline that results.

Compliance with Regulation FD

Information regarding a potential earnings miss is, of course, likely to be highly material, and no one who is aware of it should trade in the company's stock. In addition, nonpublic interactions with investors and analysts while in possession of this information creates a risk of selective disclosure. Some companies have adopted "quiet periods" in the days and weeks leading up to the quarterly earnings release, which may help avoid putting the company and its representatives in awkward circumstances.

A pre-release can also address that risk, and it may be preferable to canceling participation in investor conferences or other investor meetings, if there is a concern that an abrupt cancelation would prompt damaging speculation and rumors. If such participation or meetings do proceed prior to the public release, company representatives will need to be well prepared regarding how to ensure they remain in compliance with Regulation FD, including by answering difficult questions about the company's current and anticipated financial performance. In that regard, because analysts can be finely attuned to variations in how company executives answer questions, note that a "non-answer" or "no comment" may itself signal something is amiss if the typical practice has been to respond to such questions.

Potential Litigation

Pre-releases of negative earnings performance, like all negative disclosures, will likely draw attention from the plaintiff's securities bar, and the basis for the information contained in the pre-release could be scrutinized in litigation. As such, it is important to ensure that the underlying facts and circumstances leading to the disclosure, as well as the text of the disclosure itself, are reviewed by an experienced securities litigator.

Precedential Effect

Pre-releasing earnings may create an expectation that a company will do so in the future under similar circumstances, which could limit the company's perceived options in the future when it is faced with a comparable situation.

Cross-Functional Support

Lastly, determining whether to issue a pre-release is not a decision that should be made in a silo. Generally, the parties involved should include the company's chief executive officer, chief financial officer, chief legal officer, investor relations head and key members of the board (such as the audit committee). External legal counsel is often involved, including litigators who can advise on how to reduce potential liability. Any pre-release should be reviewed by the disclosure committee (if any) and outside auditors. The company also should provide the New York Stock Exchange (NYSE) or Nasdaq, as applicable, with advance notice of the pre-release.

Conclusion

Whether to pre-release financial results involves many legal, investor relations, and practical considerations, including those discussed above. When faced with the decision regarding a potential pre-release, companies would be well advised to work closely with their external legal advisors, public relations, and investor relations professionals and accountants.

Note

1. This article does not address other contexts in which a public company may choose to pre-release earnings, such as in advance of a pending capital markets transaction.

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