Freshfields

BOARD MEMO 2021

A GUIDE TO TAKING ON THE RECOVERY ERA

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Positioning a company for the future is a delicate balancing act. Boards setting strategy for 2021 and beyond must manage the risks that flow from the pandemic while ensuring their businesses are primed for the opportunities ahead.

In this, the 2021 edition of Freshfields' annual board memo, we set out the key considerations for directors of US public companies with the world on the brink of a recovery. In a series of insights, articles and podcasts, our attorneys discuss the trends that will shape the year to come and offer practical guidance on how best to respond.

Taking on the recovery era will require careful strategizing and bold decision-making. We hope the thinking that follows will help you do just that.

Best wishes from us all at Freshfields for a healthy and prosperous 2021.

Executive summary

Managing environmental, social and governance considerations

While ESG has been steadily increasing in importance year after year, the pandemic has catapulted the "E" (environmental) and the "S" (social) to the top of board agendas. As boards and management teams prepare for, and adapt to, the recovery period ahead, strategic and deliberate management and disclosure of E and S topics will provide a competitive advantage. In particular, boards should be mindful that:

- investors and proxy advisory firms alike will be carefully scrutinizing executive compensation-related modifications in the proxy season ahead, and therefore companies should carefully craft disclosure explaining any changes;
- as a result of mounting pressure from investors and other stakeholders – as well as recently adopted SEC rules focused on human capital management – companies will need to disclose more information about how they manage their most important asset: their workforce;
- companies will also need to steer clear of new trends in litigation focused on diversity by ensuring they have a robust process for developing internal diversity-related goals and for disclosing their diversity initiatives, as well as avoid allegations of human rights violations by reviewing the adequacy of corporate compliance and supply chain programs;
- investors and other stakeholders are expecting to see additional climate and other environmental-related disclosures, especially as the SASB and TCFD frameworks gain increasing traction, and the SEC is expected to adopt climate-related environmental disclosure requirements in 2021; and
- there is mounting evidence that this focus on ESG and sustainability has concrete economic benefits for companies, as those with better ESG profiles and track records tend to have equity (and debt) that trades more favorably than companies with poorer performance, underpinning the expectation that the growing trends of green and other sustainability bonds will continue in 2021.

Adapting to significant changes in shareholder meeting practices

Another profound shift that has taken place over the past 12 months and is now expected to have lasting consequences is in relation to shareholder meeting practices. In particular:

- we expect that, for many companies, the shift from in-person to virtual shareholder meetings will be permanent, with a greater focus on logistics, accessibility concerns and a better simulation of the in-person experience; and
- the SEC's amendments to Rule 14a-8 (which governs the shareholder proposal submission process) coupled with the limitations imposed on ERISA fiduciaries' ability to vote for shareholder proposals unless they demonstrably have an economic impact on the ERISA plan may severely curtail the ability of shareholders (especially smaller shareholders) to use the shareholder proposal process to influence corporate ESG agendas. The question that remains is whether the Biden administration will seek to reverse (at least to a certain extent) any of these changes.

Navigating the M&A landscape

The pandemic has altered the dynamics of M&A. However, the changes present significant opportunities for companies that are well advised and well prepared.

- The recovery era will see enhanced dispersion, with winners and losers. This will create opportunities for stronger companies to capitalize on favorable M&A and financing environments, while requiring those that are more vulnerable to address their weaknesses and communicate the value of the standalone plan to investors more effectively.
- We also expect that corporates will continue to play an increasingly proactive role in venture and growth-stage investments, creating significant growth opportunities while also posing unique liquidity and reporting challenges that boards and management teams will need to consider carefully.

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- In the tech sector, digital resilience will be critical to success through the recovery era and many companies will leverage M&A as the best way to build their technological capabilities. These businesses will need to navigate specific obstacles, including evolving IP and privacy regulations around the world, the more active role of CFIUS in reviewing and clearing transactions, and a more coordinated global antitrust environment that will have a significant impact on the tech sector.
- Antitrust enforcement and the involvement of foreign investment review regimes, including CFIUS, are expected to increase with the potential to impact a greater number of transactions.
- As a backdrop to this dynamic M&A landscape, companies will need to understand the changing business model of activism and adapt their business and practices accordingly – especially with ESG now often part of an activist's core strategy – to keep hungry activists and other more active-leaning investors at bay after a more muted 2020.

Mitigating risk in an active enforcement and regulatory environment

Periods of crisis are generally followed by waves of enforcement activity and regulatory scrutiny. We expect the post-COVID-19 recovery era to be no different. In particular:

- regulators will look to prosecute any fraud and other misconduct by executives and employees during the crisis, leveraging an increased commitment to global cooperation and a more sophisticated arsenal of tools perfected following the financial crash of 2008;
- privacy regulations are spreading to many jurisdictions, increasing the difficulties of compliance – and the risk of enforcement – for companies that operate globally;
- the sanctions and trade arena promises to be highly fraught, with 2020 having been a particularly active year for sanctions against China and Chinese companies; and
- companies (and higher income individuals) will face higher taxes, including an increase in the corporate tax rate from 21 percent to 28 percent and increased taxation of the revenue of multinational corporations if proposals issued by the incoming Biden administration are adopted into law.

Avoiding litigation risk

The pandemic has increased the role of the board in overseeing how companies have managed through the crisis. This is likely to continue as businesses shape how they will emerge from the economic downturn. However, this oversight exposes boards to increased scrutiny and litigation risk.

- While *Caremark* failure of oversight claims are notoriously difficult to prove, the last year has shown that Delaware courts may sustain *Caremark* claims at the pleading stage when there are factual allegations of purported failure of oversight relating to "mission critical" risks. While these cases usually have unique facts, they nonetheless reaffirm the need for boards to maintain thorough, careful records reflecting the steps taken as part of their oversight duties.
- There has also been continued increase in the use of Section 220 demands by stockholder plaintiffs to bolster their claims prior to litigation. A decision by the Delaware Court of Chancery raises further unanswered questions relating to the future use of Section 220 demands, including the ability of stockholders to bring inspection actions outside of Delaware, and the potential viability of contractual waivers of inspection rights.

We examine the themes that will dominate corporate agendas in 2021

Compensation disclosure at the top of proxy season agenda

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The impact of and ongoing uncertainty surrounding COVID-19 has caused compensation committees to revisit their companies' short- and long-term incentive award programs.

Some are considering options including adjusting quantitative metrics (and potentially moving to a targeted range for financial metrics rather than a single number), increasing the weighting of qualitative goals for performance-based awards, and utilizing relative rather than absolute performance indicators (e.g., relative total stockholder return) that reward progress compared to a company's peer group or industry (thereby dampening the impact of the pandemic). However, any committee thinking of implementing more qualitative measures or discretion for performance-based awards should exercise caution; the proxy advisory firms may take an unfavorable view if they see them as disproportionate to prevailing peer group trends or presenting a pay-for-performance misalignment. While some proxy firms have indicated they may be more forgiving in the circumstances, companies anticipating changes to their incentive award programs should work closely with their compensation consultants.

Alongside this, companies should think carefully about how to explain executive compensation decisions in their proxy statement's compensation discussion and analysis (CD&A) disclosure in the context of the compensation committee's overall philosophy in response to COVID-19. This is particularly important for committees that have exercised discretion, revised performance metrics or otherwise altered compensation in a way that could be viewed as disproportionate or resulting in an *ex post facto* windfall to executives. Compensation committees that have not already done so should develop a process and framework for reviewing the appropriateness of any changes in determining 2020 annual incentive payouts. This process and framework will allow companies to explain the rationale behind the compensation committee's decisions in the CD&A. For example, the CD&A may discuss whether the committee reviewed the company's performance relative to its peers, its ability to meet cost-cutting measures or liquidity objectives, or its ability to stage a recovery or prepare for one when approving compensation changes.

More generally, companies that have implemented workforce-related cuts, broad-based salary reductions or other similar events affecting their workforce in response to COVID-19 are likely to see increased scrutiny of their executive compensation decisions and should develop a strategy to thoughtfully reflect this in their CD&A. Although a company's CD&A technically is required to discuss only named executive officer compensation, we recommend addressing general COVID-19-related workforce events this season in order to provide greater context for any compensation-related decisions made with respect to the named executive officers, demonstrate alignment with the company's overall compensation strategy, and, if applicable, highlight cost-cutting measures in the wake of the pandemic.

Further insights

Blog: Compensation-related considerations for the 2021 proxy season

Increasing focus on human capital management and diversity

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Employees, investors, customers and other stakeholders are focused on how a company manages its people.

Over the next year, public companies in the United States will therefore be expected to convey information about their human capital management (HCM) to these groups. Stakeholders will be looking to human capital information to understand how a company and its board are approaching the COVID-19 recovery era, the impact of any lessons learned from the past year and for details on how the company will be managed in the future. The ability to attract, retain, train, incentivize and protect workers is a critical element of any company's strategy and poor HCM oversight and execution, broadly defined, may be perceived to be a growth-limiting factor, if not a misalignment among priorities and stakeholders. Furthermore, HCM is an area in which the interests of many stakeholders converge, providing an opportunity for messages to resonate synergistically, but also with the potential for issues to quickly become significant reputational challenges. While part of this expectation is driven by the new SEC disclosure rules, these principles-based requirements are a minimum and unlikely to satisfy stakeholders. Early disclosures are yielding a wide range of approaches to the SEC requirement with respect to subtopics, level of detail, use of metrics and length, among other factors.

One of the challenges and opportunities is the lack of an agreed-upon definition of the components that comprise HCM. As a result, the first step for many companies is to specify these parameters. There is, however, a growing expectation that diversity and inclusion initiatives will be included in HCM oversight. After the significant and important societal issues brought to the fore in 2020, stakeholders are turning to companies and expecting progress. We can see this through new racial and ethnicity board diversity requirements in California, the ISS and Glass Lewis proxy voting guidelines, diversity-related derivative lawsuits, shareholder proposals and settlements regarding pay gap information, and the continued engagement and assessment by institutional investors regarding a company's progress on overall diversity. The areas of focus are increasing – from the boardroom to leadership and employees. In addition, the ability of smaller companies to wait for the trend to trickle down no longer exists, nor is it feasible for companies to make little incremental progress because they compare favorably to peers or their index. With the increase in overall investor resources for governance – and the increasing appetite for progress in these areas – companies are being reviewed on their own performance.

The good news for directors is that there are no secrets to doing well in these areas. While it can be challenging to implement and oversee, and the individual details are critically important, the recipe is constant. Establishing oversight, making incremental gains, having a mechanism for assessing progress and effective communication with stakeholders are the elements of a successful HCM and diversity program.

Further insights

Blog: Practical tips on incorporating new HCM disclosures into annual reports
Blog: Diversity in boardrooms continues to gain momentum
Blog: ISS updates its voting policies
Blog: A guide to contextualizing the 2021 ISS proxy voting guidelines
Podcast: Human capital management

The new flavor of shareholder derivative actions – diversity litigation

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In the summer of 2020, the boards of multiple large public companies were sued by shareholders because they had no African American directors. The lawsuits are styled as shareholder derivative actions, ostensibly brought on behalf of the companies themselves, and seek hundreds of millions of dollars in damages and new corporate programs. Plaintiffs allege that directors breached their fiduciary duties under state law by failing to appoint black directors, whose service on boards plaintiffs argue is positively correlated with higher profits. Plaintiffs also claim that directors violated the federal securities laws by falsely touting their commitment to diversity in proxy statements.

While board diversity is both valuable and overdue, these lawsuits suffer from multiples deficiencies that arguably undermine diversity. Plaintiffs seek to usurp the traditional deference that state corporate law has afforded to the business judgment of directors, by adopting a narrow and rigid definition of diversity that fails to take into account gender, sexual orientation or even other races.

Unsurprisingly, the lawsuits cannot identify any legal authority requiring directors to pursue a single definition of diversity; to the contrary, recent legislative developments, such as a new board diversity statute California enacted in September 2020, emphasize the many dimensions of diversity and allow boards a period of several years to comply with the new mandates. That such mandates did not exist until this year reinforces the conclusion that directors could not have breached an existing fiduciary duty. Plaintiffs' federal law claims fare no better, failing to meet elementary pleading requirements such as identifying a materially false statement or showing that such a statement harmed the corporation.

Boards facing these new diversity mandates or simply seeking to enhance diversity should avoid the distraction of such lawsuits by focusing on well-articulated internal diversity goals, sustained outreach to talented candidates, and robust disclosures that clearly identify the company's diversity initiatives (in addition to complying with the new human capital reporting requirements the SEC added to Regulation S-K in August 2020).

Further insights

Interview: Boris Feldman interviews Frank Bottini

Companies, directors and officers as targets of allegations of human rights violations and other litigation trends

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One litigation trend that directors and senior management should monitor closely in 2021 is the increasing incidence of claims brought by human rights activists seeking to hold companies, as well as corporate directors and senior management, accountable for human rights abuses committed by the corporation or within its supply chain.

In early December, the United States Supreme Court heard arguments in *Nestlé USA Inc. v. John Doe 1 et al*. In that case, plaintiffs – allegedly survivors of child slavery – sued US corporations for violations of international law under the Alien Tort Statute (ATS), alleging that defendants turned a blind eye to red flags of child slavery occurring on farms from which defendants sourced supplies. In 2018, the Supreme Court held that the ATS does not provide a basis for exercising jurisdiction over foreign (i.e., non-US) corporations under the ATS, but suggested that claims against directors, officers and employees may survive. We anticipate that the Supreme Court will reach a similar decision in *Nestlé* with respect to US corporations. But, with companies outside the scope of the ATS, we anticipate activist plaintiffs will increasingly target corporate directors and officers for any perceived misconduct on the part of the corporation, arguing that directors and officers turned a blind eye to human rights abuses within the company's supply chain and/or failed to investigate red flags brought to the company's attention. Given the potential reputational and economic risks posed by such claims, we recommend that senior management take steps to mitigate the risk of their being brought. We note that, in at least one case, the existence of such corporate compliance programs proved useful in obtaining dismissal of human rights claims brought by activist plaintiffs.

In addition, directors also should remain alert to the ways in which litigation is increasingly being conducted on a global basis. For example, class actions are no longer a US-only concern. The European Commission is on the verge of formally enacting its Collective Redress Directive, which will require each member state to ensure that class claims can be filed on behalf of consumers affected by breaches of various EU consumer protection laws – including GDPR, product liability, and unfair contract terms or trade practices. As each member state considers whether and how to adapt their laws to implement the directive over the next two years, companies will have an opportunity to influence national approaches through individual or industry association lobbying on issues such as the standard for class certification and the amount of permissible discovery. Indeed, with discovery increasingly crossing borders (including the ability of foreign litigants to get broad US-style discovery in the United States for use in foreign proceedings pursuant to Section 1782), boards also may want to re-examine their corporate structure and ensure the maintenance of intra-company governance hygiene; be thoughtful about where certain operations occur (and which employees are involved); and consider technology issues such as the location of computer servers, the use of shared domains and how information is exchanged across borders. Most critically, boards should ensure they and their legal teams are prepared to

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coordinate immediately on litigation strategy across multiple jurisdictions and able to respond nimbly when litigation is filed.

Finally, with vaccines slated for deployment we are set for a recovery in 2021. However, medical and public health literature suggests that further global pandemics are possible, even likely. With that in mind, companies would be well advised to take lessons from our experience litigating a number of COVID-19-related commercial disputes and review their existing and future contractual forms.

In particular, they should pay attention to boilerplate provisions such as *force majeure*, adequate assurance and termination clauses to make sure the company is best positioned to survive and thrive should further business interruption events occur. Similarly, if a company intends to engage in material corporate transactions, boards and senior management should pay particularly close attention to how MAC/MAE clauses are framed to ensure the desired amount of deal certainty, even in the face of events that destabilize the market.

Forecasting climate change and sustainability efforts in 2021

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As we enter 2021, there are signs that expectations around climate change issues will begin to coalesce and investor and regulatory expectations may become more focused. In recent years, companies that made efforts to convey climate change information to investors invariably found that expectations lacked standardization and, worse, that significant investment in compliance with third-party standards or compliance with a ratings framework was not universally understood or appreciated.

There have been early indications that the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD) are gaining traction with companies and investors alike. This is due in part to BlackRock's endorsement of the frameworks in Larry Fink's annual letter to CEOs at the beginning of 2020, and the expectation that companies provide public SASB- and TCFD-compliant information. Toward the end of 2020, SASB announced its merger with the International Integrated Reporting Council (IIRC), which by the middle of 2021 is expected to be called the Value Reporting Foundation. In addition, SASB, along with a group of international sustainability accounting standards organizations including IIRC, Global Reporting Initiative (GRI) and the Carbon Disclosure Project (CDP), announced a statement of intent to create a more comprehensive corporate reporting environment, in part by providing joint guidance on how their respective standards and frameworks are complementary or additive, with BlackRock calling for a convergence of standards into a unified reporting framework.

A recent report by the Governance & Accountability Institute revealed that 90 percent of S&P 500 and 65 percent of Russell 1000 companies published sustainability reports in 2019. Companies that have resisted providing climate and sustainability disclosure should expect that, in 2021, investors and other stakeholders will be less persuaded by arguments attempting to justify the absence of sustainability-related information, absent a compelling justification.

Companies should also expect to see the SEC take on climate-related disclosure, as the incoming Biden administration has indicated that climate change will be one of the administration's top priorities. While the current and prior SEC regimes have resisted prescribing disclosure and other regulations tied to climate change, it is expected to be an area of focus for the upcoming year.

Sustainability and "building back better"

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Anyone expecting sustainability to fall out of focus amid the response to the pandemic was wrong. Companies with strong environmental, social and governance (ESG) scores have proven more resilient through 2020 and have outperformed the market.

There are several complementary factors that explain their success and point to a 2021 where investors and governments insist corporate recovery plans feature a "building back better" focus on ESG matters.

These factors include the following:

- Companies with better sustainability credentials benefited in the crisis from stronger relationships with stakeholders, including customers, suppliers and employees.
- Many governments, especially in Europe, have insisted that if trillions of dollars are required to rebuild their economies, those investments should be used to reduce emissions and drive other positive environmental and social impacts. The United States has not yet tied stimulus funding to ESG goals, but this could change in a Biden administration.
- The vulnerability of global supply chains was laid bare by COVID-19, highlighting the benefits of both the low energy expenditure and resiliency of local sourcing. Further, as resources generally become more scarce, circular solutions that promote the reuse of products and materials are likely to thrive.
- Employers with the most advanced diversity programs engendered greater loyalty among employees and consumers in the face of global protests for racial justice.
- The Biden administration will see the United States rejoin global efforts to combat climate change with increased regulation and business incentives. For example, the President-elect proposes to achieve a carbon pollution-free power sector by 2035.
- Recent moves by the US Department of Labor (DOL) to limit the flexibility of fiduciaries of private sector retirement and other employee benefit plans to consider ESG factors in their investing strategies will be frozen or terminated in a Biden administration. This includes the DOL rule passed just days before the election requiring ERISA plans to select investments based on so-called pecuniary or financial factors, rather than other goals or nonfinancial objectives.

Given these regulatory and investor dynamics, boards and senior leaders will need to get out early in 2021 with their "building back better" strategies by:

- using authentic sustainability brand management to improve customer loyalty;
- ushering in Workforce 2.0 approaches to employees that facilitate remote working and enable diversity to flourish at all levels of seniority;
- vetting global supply chains and nurturing local networks for essential goods, ideally based on circular economic principles; and
- tapping into growing green financing pools for both environmental and social projects.

Further insights

Website: New York Circular City Initiative, convened by Freshfields

Blog: Freshfields' sustainability blog

Sustainable financing – a win-win?

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Green bonds and similar variations, including social bonds, sustainability bonds and transition bonds, are debt instruments whose use of proceeds is earmarked to fund sustainability-related projects.

Because there is no widely accepted definition of sustainability, or even of ESG (environmental, social and governance), issuers have wide latitude when deploying the proceeds from these financings. Recent examples have included energy efficiency and clean energy projects, investments in green buildings and clean transportation, circular economy initiatives, affordable housing projects, a commitment to racial equity and, in light of the pandemic, support for small businesses and COVID-19 recovery. As part of the financing process, issuers commit to publishing a report on the allocation of proceeds, typically accompanied by an independent third-party assessment confirming this allocation of proceeds and the compatibility of chosen projects with investment eligibility criteria.

Green bonds are having their moment right now. Reportedly, not only are they often oversubscribed by investors, but they also tend to lead to more favorable pricing terms for issuers compared to their non-green equivalents. In many ways this is not surprising: for years we have seen investors' focus on, and appetite for, ESG increase. For example, money continues to shift from actively managed funds to passive strategy funds (including index funds such as BlackRock, State Street and Vanguard), which have been at the forefront of the push toward better corporate ESG practices. Similarly, demand for impact investing is robust, standing at an estimated half a trillion dollars for 2019. It is not surprising, therefore, that companies benefit by attracting these ESG-focused investors.

But this trend is not only confined to green bonds; in fact, similar dynamics are also present in the equity markets. In particular, we have seen strong demand from impact investors in the IPOs of mission-driven companies, including, in 2020, the IPOs of two "public benefit corporations." Conversations with investment bankers on this topic have indicated that companies with better ESG profiles and track records tend to have equity (and debt) that trades more favorably than companies with poorer performance.

Therefore, whether it be the issuance of green or other sustainable bonds, conversion to a public benefit corporation or simply an increased focus on ESG performance, as companies evaluate the relative benefits of their sustainability social initiatives (many of which are highlighted throughout this publication), boards and management should not overlook the potentially favorable financial impact of these commitments, too.

Further insights

Blog: The factors that shift the balance on converting to a public benefit corporation

A roadmap for planning virtual annual shareholder meetings

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As we enter 2021, the question of how to handle spring annual shareholder meetings looms large. While cases of COVID-19 continued to surge throughout the fall of 2020 and states urged people to stay home and take precautions, the promise of a vaccine came ever closer with hints that "normal" life may resume as early as Q2 of 2021, when annual meetings are being held.

What we learned in 2020 is that the virtual-only shareholder meeting model works; contested virtual meetings were successful, and nearly an entire market pivoted just as proxy season began. However, while many agree with the efficiency and accessibility benefits of virtual shareholder meetings, they are still not universally accepted by investors and other stakeholders.

With this in mind, companies considering a virtual-only meeting should consider the following.

Some investors required companies to commit to returning to in-person or hybrid meetings in order to receive favorable votes in 2020. As we move into 2021, those investors have not yet publicly stated whether they will hold companies to their commitments in the year ahead. If a company that committed to reverting to a virtual-only meeting wishes to continue with a virtual meeting in 2021, advance engagement with investors will be helpful to assess stakeholder views and provide companies a chance to explain why virtual-only shareholder meetings are appropriate.

Other investors do not favor virtual-only shareholder meeting formats but stopped short of requiring commitments and gave wide latitude to companies in 2020. Disclosure in the proxy statement about why a continued virtual-only meeting format was chosen may be persuasive to those investors.

As companies and vendors rolled out virtual meetings, some shareholders noted kinks related to meeting accessibility and opportunities for shareholder engagement and participation. Companies can expect there to be little forgiveness for these issues in 2021. It will likely be helpful for companies holding a virtual meeting in 2021 to explain how improvements are being implemented.

Some states continue to prohibit virtual-only shareholder meetings and companies relied upon executive orders, some of which were last minute and vague. In these states, extensions to existing executive orders or new executive orders may be necessary in order for companies to plan a virtual-only meeting in 2021.

Time will tell whether companies can feasibly return to in-person meetings, and it is possible that there will be variation based on geographic location, industry or other considerations. As companies think about meeting formats, they should be prepared to communicate with their stakeholders, build flexibility into their plans and be ready to pivot on short notice.

Further insights

Podcast: Virtual shareholder meetings

Impact of the changes to the SEC shareholder proposal rules and proposed DOL regulations

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The SEC's changes to the shareholder proposal eligibility requirements under Rule 14a-8 will be effective for proposals submitted toward the end of 2021 in advance of the 2022 proxy season. However, it is likely that companies will perceive changes in the tenor of shareholder engagement earlier than the fall of 2021, as the eligibility requirements are expected to alter the dynamics of the so-called off-season governance engagement because they affect the stakes for proponents and shareholders. Shareholders that are potential proponents will likely commence balancing portfolios in order to maximize shareholder proposal eligibility and may use formal and informal engagement efforts to determine the feasibility of alternative engagement methods prior to making such portfolio-balancing decisions.

In addition to the procedural changes to Rule 14a-8, in September 2020 the Department of Labor proposed regulations regarding the requirements of an ERISA fiduciary (which includes most US private pension funds) to comply with its fiduciary duties and its ability to vote for proposals at annual shareholder meetings and engage in stewardship activities (including the submission of shareholder proposals).

The proposals clarify, among other things, that:

- there is no affirmative duty for an ERISA fiduciary to exercise its voting authority; and
- in order to vote on a proposal or engage in stewardship, the fiduciary must determine that the matter would have an economic impact on the plan.

Given the size and diversity of their assets, individual matters are unlikely to have an economic impact on large plans. While it is unclear whether the proposed regulations will be finalized – and in particular whether the incoming Biden administration will take a different stance – ERISA fiduciaries are likely to take a conservative approach this proxy season due to the chilling effect of the proposal, even in advance of any finalization. In addition, private pension funds and other investments regulated under ERISA have been influential in supporting smaller shareholders. In particular, the combined effect of a finalized Department of Labor proposal and the resubmission thresholds under Rule 14a-8 will make it difficult for smaller proponents to meet the revised resubmission thresholds to grow shareholder support for identical proposals in successive years to significant and even passing levels – a popular tactic that has tended to be utilized by less well-capitalized proponents relying on support from larger environmental, social and governance-attentive shareholders such as private pension funds.

Companies should have their IR departments determine whether and how these developments will impact shareholder engagement programs, and boards should consider how their companies should prepare to shift their

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engagement strategy in light of this new regulatory environment. One of the reasons the SEC cited for amending the Rule 14a-8 eligibility requirements is the availability of other forms of engagement and communication to shareholders so it is reasonable to expect increased focus on such other forms of engagement. In some ways, the Rule 14a-8 process was a statutorily prescribed and therefore preferred single, organized manner for smaller shareholders to engage with companies. The inability, or perceived inability, of shareholders to reliably access alternative engagement channels where the Rule 14a-8 process is actually or potentially no longer available to them is likely to result in a more fractured shareholder engagement process, for which companies will need to prepare and adapt. Recent experience has shown that the failure of a company to be viewed as responsive to its stockholders (and, increasingly, its stakeholders) may have a significant adverse reputational impact even if it does not have an actual governance impact.

Recovery era M&A

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The investor landscape as recovery era M&A driver

Investors now view M&A as an efficient means for most issuers to achieve short-term increases in trading multiples (through bolt-ons and divestitures) or premiums (when selling the whole company). Clients facing this pressure include many outperformers. For investors, outperformance is not an excuse to stay away from M&A if a multiple bump is within reach through a divestiture or acquisition. Moreover, investors are rarely inhibited by the regulatory hurdles or complexities when pushing for M&A.

Additionally, within the investor community the continued shift of money away from actively managed funds (such as T. Rowe, Fidelity and Capital) is putting pressure on them to outperform in the near-term, which in turn drives them to push the issuers in their portfolios to engage in M&A. Meanwhile, the bonds between the passive strategy groups (ETF and index – e.g., BlackRock, State Street, Vanguard) and the true activists continue to grow (e.g., as the activists profess allegiance to ESG concerns). In return, we expect the passive strategists to support the M&A alternatives for which the activists push.

Macro forces further fuel deal activity

The recovery era will see enhanced dispersion – we are entering a time of winners and losers – which results in overwhelming pressure to be grouped with the winners. Many CEOs view M&A as a vehicle to achieve this outcome. Especially in battered industries, we are seeing clients aggressively seeking to emerge as consolidators. Additionally, the competition among both cash-rich and distressed companies to acquire business lines that will be favored by the recovery era is fierce.

The availability of financing, whether from banks and capital markets for the financially healthy or equity PIPE financing for those with more challenged financial conditions, further fuels these M&A strategies. In addition, the markets have looked favorably on a number of businesses during the period leading up to the recovery era and therefore, whether or not their equity is publicly traded, they are entertaining the use of their stock as acquisition consideration.

Finally, some "winners" may emerge too strong, and we will therefore see divestitures either mandated by antitrust authorities or preemptively taken on to mitigate antitrust scrutiny – both within and outside the context of transaction clearance processes.

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Valuation disconnects will haunt recovery era M&A

The recovery era will be characterized by market volatility, disconnects between internal management forecasts and Wall Street forecasts, and uncertainties about macro factors. These dynamics will make meetings of minds on valuations difficult. We are already seeing an increasing tendency to try to lean on earn-outs and contingent value rights (CVRs), and creative exchange ratio formulas to bridge the gaps.

Moreover, in anticipation that it will not be possible to bridge these gaps, buyside clients are dusting off their hostile bid playbooks of bear hug letters, strategies for tender offers to function as symbolic market referenda in the face of poison pills, buying shares to have standing to bring fiduciary duty litigation against target boards, and planning proxy contests to replace directors supporting poison pills and opposed to exploration of strategic alternatives.

Longer periods between sign/close and enhanced regulatory execution risk will impede recovery era M&A

The emergence in recent months of enhanced foreign investment regimes across the world (including the material expansion of CFIUS reviews) and bold antitrust scrutiny of mergers will lead to longer periods between signing and closing.

The consequences of this will include further need for creativity in interim operating covenants (compounding the difficulty of figuring out how to articulate what is "ordinary course" in times that are dynamic and extraordinary), innovation in addressing needs for financing by target companies between sign and close – especially in the case of targets that are burning cash (e.g., buyers may have to serve as sources of credit to help their targets make it to closing) – and increasing pressure on the covenants, conditions and reverse termination fees that allocate the risk and specify the procedures for addressing execution risks arising from regulatory clearance requirements.

As more deals in the coming months fail to reach the finish line – notwithstanding undertakings that had been described to the target boards as having been guaranteed by the acquirors' "hell or high water" commitments – regulatory covenants in merger agreements will need to become more granular to permit efficient specific performance suits by targets and sellers.

Corporates cement their position among minority investors

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After years of being followers in venture and growth-stage investments routinely led by VC funds and other "usual suspect" financial investors, corporates have now become established players in early- and later-stage private company financings. And while corporates shied away from the risk of minority investments during the 2009 financial crisis, in 2020 they stepped up to the plate, many with cash to spend during a period that offered unique opportunities including due to decreased competition from financial investors who took a step back early on in the pandemic. Corporates' increased exposure to minority investments, when combined with the new features, challenges and opportunities created in 2020, requires boards and management to take a fresh look at their portfolio investments and approach to future investments.

Early in the pandemic, commentators predicted a wave of down rounds, perhaps coupled with a greater ability of investors – financial sponsors and corporates alike – to negotiate stronger governance and economic rights than those the market had largely coalesced around prior to the crisis. In reality, although some of those scenarios have materialized, we have not seen investors dramatically change the course around terms such as redemptions (more likely than not, investors do not have a put right), liquidation preference multiples (1x remains the norm), pay-to-pay provisions (typically only in down rounds) and consent rights (which continue to vary deal by deal). So, while corporates may be well positioned to invest as we enter 2021, they should not expect deal terms to have shifted significantly. And they may find themselves more frequently leading early-stage financings, as data shows that while financial firm investments have not declined overall in 2020 they have shifted somewhat away from early- to later-stage financings.

The IPO exit on the other hand has a new flavor this year, with the resurgence of SPACs offering private companies a path to the public markets. And after an IPO downturn early in the year, the Q3 surge in regular-route IPOs is now expected to continue. Add direct listings to the choice of routes to public company status, and corporates have a high likelihood of becoming a public company shareholder. Corporates need to ensure they have a mechanism in place to manage public company portfolio investments, including an understanding of restrictions on resale, registration rights and other liquidity options.

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When making an investment, it will be essential going forward to ensure that liquidity rights apply to stakes in public companies that have become public not only through a traditional IPO. Depending on their relative ownership percentage and governance rights at the public company, corporates will also need to manage required regulatory filings with the SEC.

With respect to M&A exits it would be unrealistic not to acknowledge that there have been success stories and distress stories in 2020, and we expect further opportunities for consolidation in certain industries that already-invested corporates are well positioned to seize. In addition, corporate investors that have had a chance to look under the portfolio company's hood can act swiftly to consummate a deal. Corporates should consider whether to negotiate a right of first offer or call option to acquire the company at the time of the initial investment. We've seen a significant number of corporates in the second half of 2020 make strategic acquisitions of portfolio companies in which they had a minority stake.

Tech transactions in the spotlight

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Digital resilience will be critical to success through the recovery era, and many companies see M&A as the best way to build their technological capabilities. However, tech acquisitions are not like traditional deals, with their value tied to a different set of factors and a complex array of regulatory issues combining to heighten execution risk.

Rather than hard assets or contracts, tech deals are typically driven by intellectual property, data and people. Boards looking to buy a tech company therefore need to understand what IP the target holds and how to secure rights over it, along with how the company collects personal data and moves it across borders. It's essential to scan the horizon for evolving regulations that could impact future plans, as well as ensuring that the individuals who have driven the company's success to date remain on board after closing. Here there are legal structures that can offer protection, but broader considerations such as cultural fit (particularly where people are moving from a startup to a corporate environment) will also play a part.

As with any deal it's crucial to get under the skin of why the business is being sold and how it's being sold (i.e., is it a merger, a tender offer or an asset purchase?) as well as assessing the deal terms against market norms. Then there are considerations in relation to fiduciary duties and whether there are any conflicts of interest for board members or senior executives, something that will be closely scrutinized if the acquisition is challenged in court.

From a regulatory standpoint, governments have been carefully reviewing the national security impact of technology transactions in recent years – not only because the innovations so sought after by businesses (artificial intelligence, for example, or robotics) are also critical to military supremacy, but also because of the potential for acquisitions of things such as large pools of personal data to pose a security threat. As its name suggests, the Committee on Foreign Investment in the United States (CFIUS) analyzes the security implications of acquisitions by foreign buyers. However, it's no longer just buyouts the committee cares about – minority investments that give foreign persons even observer seats on the board of a US target, and joint ventures between US companies and overseas businesses, are now also in their sights. While CFIUS pays particularly close attention to Chinese investments, foreign deals (including from "friendly" countries) targeting sensitive US technology, data and/or infrastructure could also be subject to conditions or blocked, depending on the profile of the investor and the sensitivity of the target. And the same is true for US companies bidding for technology assets overseas, with national security front of mind for regulators across the world.

Antitrust authorities, too, have turned their attention to tech, with the Biden administration set to usher in increased antitrust enforcement which, when combined with a new era of international antitrust cooperation, will have a major impact on technology transactions. Many such deals involve large tech companies buying startups that could have become competitors had they remained independent, yet in the past these acquisitions have often

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flown under the antitrust radar because they were too small to trigger notification requirements (as is the case in Europe), or because the enforcement agencies simply chose to let them through (for example in the United States). Now, however, with tech companies growing more powerful through the pandemic and a widespread desire to protect consumers hit hard by the economic fallout, these so-called "killer acquisitions" will be reviewed to a much greater extent and are increasingly likely to be challenged. The European Commission has announced that it will now scrutinize deals which previously were too small by investigating any deal referred by a member state whether or not it crosses the reportability threshold, while we expect much closer engagement between the US antitrust agencies and their European counterparts as they look to align on "theories of harm" that will give both sides more chance of exerting their influence over deals.

What this means in practice is that boards of bidding companies (as well as startup founders and investors looking for an exit) will need to conduct a much more thorough antitrust risk assessment from the outset of a transaction and put in place contingency plans to deal with any regulatory challenges. Likewise, this increased execution risk must be reflected in the deal terms.

> Further insights

Podcast: Tech transactions in the spotlight

The antitrust outlook

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Antitrust continues to be in the global spotlight and is a key risk to consider when evaluating M&A and strategic plans.

We anticipate companies and dealmakers in 2021 will face even greater antitrust scrutiny as policymakers and enforcers around the world continue to question whether current enforcement levels are sufficient to achieve the aims of competition policy.

The global pandemic and resulting economic downturn have only heightened these concerns, as life sciences and big tech companies have benefited from the global disruption while companies in other sectors – and their employees – have struggled.

The Biden administration is expected to support tougher antitrust enforcement. We will see new leadership at the Federal Trade Commission (FTC) and Department of Justice (DOJ), who will steer enforcement priorities for the next four years and may back legislative reforms to increase government oversight. Even absent legislative change, Congressional support for increased enforcement likely will result in added FTC and DOJ scrutiny of deals and commercial conduct by large companies.

These three areas deserve board attention in the coming year.

1. Expanded theories of harm in horizontal mergers

Direct horizontal overlaps will continue to be front and center in merger reviews, but other theories of harm are gaining traction. Around the world, enforcers are increasingly focused on so-called "killer acquisitions" of nascent competitors. They also are looking more closely at minority acquisitions and cross-shareholdings that could mute incentives to compete and facilitate information-sharing. In addition, regulators outside the United States have required remedies in deals raising conglomerate or broad innovation-related concerns. It is therefore increasingly important to assess deals with respect to these less-common theories of harm.

2. Greater scrutiny of vertical transactions

There are signs that the FTC and DOJ may scrutinize deals that combine firms in different parts of a supply chain more closely following publication of new Vertical Merger Guidelines in 2020. Companies should not presume that such transactions will be viewed as procompetitive and should pay particularly close attention to antitrust risk when one of the two parties to a vertical transaction operates in a relatively more concentrated industry.

3. Increased focus on digital markets

Lawmakers on both sides of the aisle have called for increased antitrust enforcement in digital markets and for greater scrutiny of large tech companies. In October, the US House Judiciary Committee issued a highly anticipated digital markets report recommending several antitrust reforms in the tech sector. Enforcers around the world also have remained active, acknowledging several ongoing tech investigations. The increased focus on digital markets on both sides of the Atlantic also may be a harbinger of broader antitrust alignment and coordination between US and European regulators going forward.

China, trade and investment – change or no change?

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Among the tools that the Trump administration used boldly was its authority to prohibit transactions or constrain trade on national security grounds. In his four years in office, President Trump ordered more deals blocked or unwound using CFIUS authorities than was the case in the preceding 30 years; imposed steel and aluminum tariffs on imports from friend and foe alike using national security authorities; and issued numerous national security-justified executive orders and regulations directly or indirectly targeting China that had a material impact on a broad range of US businesses.

In a Biden administration we are not likely to see actions that characterize allies as national security threats, or a government reduced to chaos by a teenage lip-syncing app. But one thing is clear: China will remain a significant focus for the national security and foreign policymakers (including the members of CFIUS) in the new administration, often with material direct or indirect impact on US companies.

For domestic businesses that produce advanced technology or have access to sensitive personal data, CFIUS will almost certainly continue to serve as a significant impediment to deal-making with Chinese companies. There may be changes around the margins where CFIUS will approve some transactions with heavy mitigation as opposed to blocking them outright, or where the government opts for what it calls a "run faster" (domestic investment) strategy to bolster US technological competitiveness rather than seeking to deny China capabilities. However, the focus on China will continue to impact not just direct investment *from* China, but US and foreign companies that either engage in business *in* China or that rely upon goods *made* in China, where the US government sees those activities as posing national security risks. This means that acquisitions even by companies from allied countries risk heavy scrutiny over their links to China.

Furthermore, these considerations do not stop at US borders. The Trump administration, notwithstanding its many steps that created divisions with allies, lobbied them aggressively on China-related priorities. These met with varying levels of receptivity, but four years later – perhaps as much because of Chinese practices than any pressure from the United States – many allies are beginning to see China through a similar lens when it comes to technology and infrastructure security. Beyond Huawei, one major by-product of this is that many countries have introduced or reinforced CFIUS-like foreign investment review regimes, a trend only accelerated by concerns over opportunistic acquisitions during the COVID-19 pandemic. Importantly for US boards, investments by US companies are subject to these reviews as well, and sometimes emerge only after lengthy investigations and under conditions imposed on the transaction.

The extent to which the United States (and its allies) "de-couple" from China remains to be seen. The strategic tension between Washington and Beijing, however, is likely to continue to be a driver of government regulatory actions on all sides that could dramatically affect trade and investment flows globally in the coming years.

Preparing for shareholder activism in 2021

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Although the level of publicly reported activism has decreased this past year, boards and management teams continue to be occupied by a regular flow of "private" activism – i.e., aggressive, non-public, inbound communications calling for changes in strategic direction, operational focus, public commitments to long-term metrics, and changes to board and management composition, all made without launching a public campaign.

Meanwhile, we are witnessing the business model of activism evolve. Activists increasingly work with private equity funds or adopt a private equity model themselves that can be deployed in parallel with an activist campaign (e.g., as a provider of PIPEs to finance operational changes or as members or leaders of consortia to acquire all or a portion of the targeted company). At the same time, we are also seeing convergence in the other direction as traditional private equity sponsors accumulate non-passive, minority positions in publicly traded companies.

The adoption of these models is consistent with the increased focus of activism on optimizing M&A activity (wholeco sales, accretive acquisitions, multiple-improving divestitures and alternatives to M&A transactions endorsed by the incumbent board), alongside advocacy relating more generally to capital allocation choices.

This M&A focus will dovetail with the upcoming recovery era and the dispersion of valuations and prospects among companies that will characterize this era. Activists will push the losers of the recovery era at one end of the spectrum to sell or retool via M&A. Winners will be urged to serve as consolidators.

Activists will also be paying close attention to the few dozen companies that adopted short-term poison pills prophylactically in the spring of 2020 as these pills start to expire in 2021 (or are renewed and thereby invite recommendations against support of the incumbent board from proxy advisory firms).

We are now working more regularly on preparing and defending unintuitive targets – e.g., companies in highly regulated markets, large caps and controlled companies – but these targets are not random. Activists continue to focus on opportunities that fit their established criteria, including underperformance relative to peers and perceptions of market undervaluation, and the underutilization or misallocation of capital.

The continued consolidation going on in the actively managed fund sector will result in further concentration of ownership in stockholder profiles and increased vulnerability to an efficiently run activist campaign – in the same way we have seen with the significant growth in passively managed funds. Actively managed funds, passive strategy funds and other institutional investors are also increasingly willing to make demands themselves, privately and publicly, that evoke tactics from the traditional activist toolkit and to pile on to campaigns led by traditional activists. This is especially true of ESG issues, where activists continue to be acutely aware of ESG

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weaknesses at their targets and to build bridges with institutional shareholders focused on elements of ESG or even to make ESG a focus of their campaigns.

As a result, and given the continued convergence of interests among different stakeholders in the public company ecosystem, boards and management teams will need to proactively incorporate substantive responses to potential activist concerns in their stakeholder engagement in order to stay out in front of such issues and keep activists at bay.

The next year in global investigations

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The recovery era's sinking tide exposes all reefs

The global economic response to the pandemic is likely to be the most important trend for many areas of legal risk in 2021, and investigations and enforcement are no exception. Prosecutors and regulators – cooperating between agencies and across borders – will be on the lookout for fraud and other misconduct by employees trying to keep their companies afloat or profit improperly from inside information amid the recent rash of bankruptcies, historically volatile securities and commodities markets, and overwhelming business pressures brought to bear by COVID-19. And like the 2008 financial crisis, this behavior will be exposed as investors liquidate their portfolios and financial institutions call their loans amid increasing rates of default.

Governments will also look to their own checkbooks for possible leads; dozens of fraud cases have already arisen from the historic relief packages authorized in the depths of the crisis, with more likely as political leaders face public pressure to ensure funds are used to restart economies, not line fraudsters' pockets. These inquiries may affect those that helped others to participate in the stimulus programs but missed red flags or inadvertently facilitated fraud. Where companies have taken advantage of pandemic-depressed valuations to engage in cross-border M&A, authorities may continue to focus on anti-bribery risks and other types of misconduct – especially when eager, hurting sellers required a compressed diligence timeline. Finally, uneven recoveries between national economies may inflame trade-related tensions as countries seek to protect wounded domestic industries and retaliate against nations believed to be playing unfairly. As companies caught between the United States and China have seen, this friction will be accompanied by more investigations, more sanctions and more regulatory risk.

Investigators have spent the last decade perfecting new tools, from more comprehensive whistleblower reward programs to new criminal statutes (such as US anti-spoofing laws) and sophisticated data analytics departments. Once the disruption passes, authorities will have a mountain of data to review and analyze, and they appear committed to the task ahead. For example, one US Department of Justice (DOJ) official already stated that the pandemic has provided the DOJ with "years and years of cases to come." The director of enforcement at the Commodity Futures Trading Commission has flagged COVID-19-related issues as a priority and said: "We now have the tools, including through the development of our data analytics program, to better test and verify the information we receive." These pre-existing trends are likely to find reinvigorated political support in the incoming administration: President-elect Biden is widely expected to pursue financial and corporate fraud more aggressively than President Trump. Indeed, many high-level regulators from the Obama years – when these tools and techniques were first implemented – are reportedly in the running for key posts or are already assisting with presidential transition efforts. As the uncertainty caused by COVID-19 recedes, the new (but experienced) team in Washington appears eager to dig into the problems it has exposed.

Privacy and cyber

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The world's most important privacy law – Europe's GDPR – went into force more than two years ago. But 2021 may be the year its shockwaves are truly felt across the globe.

GDPR copycat laws are now taking hold in some of the most important jurisdictions. Brazil's privacy law, modeled closely on the GDPR, finally took effect in August 2020; South Africa's came into force a month earlier and enforcement starts in July 2021. India continues to consider its comprehensive Personal Data Protection Bill, spurred by a landmark Supreme Court judgment declaring privacy to be a fundamental right. And in late October, China began consultations on a GDPR-inspired Personal Data Protection Law. The enactment of these measures will complete the expansion of comprehensive private sector privacy laws across the BRICS. Meanwhile, the California Consumer Privacy Act went into effect at the start of 2020, and now California citizens have adopted a supplemental law (the California Privacy Rights Act) that will bring the state's regime even closer to EU standards. The bottom line is that companies need to plan for an environment where privacy laws give individuals substantial rights over personal data that businesses previously regarded as a proprietary asset.

Alongside this, the world continues to grapple with the *Schrems II* decision, in which the European Court of Justice applied GDPR to invalidate a key mechanism for moving personal data from Europe to the United States. In 2021, expect the decision's impact to be felt in two ways. First, other countries with GDPR-like laws may follow the *Schrems II* reasoning and similarly restrict transfers to the United States. Second, EU member states may start looking at jurisdictions other than the United States – in particular those with powerful surveillance authorities – and restrict cross-border transfers there, too. Meanwhile, the US government's orders against TikTok and WeChat show how even a country without a comprehensive privacy regime can use other measures (such as sanctions) to restrict personal data flows.

Finally, expect greater activism by private individuals and organizations in the privacy space. Europe's baby steps toward mass-claim regimes have created fertile ground for self-appointed privacy champions to bring large-scale litigation against companies for perceived privacy failings. Across the globe, these advocates have rapidly garnered a popular following that gives them real influence in the marketplace.

What 2021 means for global sanctions and trade

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In 2020 the long-simmering United States–China trade war accelerated, with each side creating or implementing new regulatory enforcement mechanisms that leverage economic pressures to achieve geopolitical outcomes. This has left many companies caught between the world's two biggest economies, struggling to avoid significant regulatory risk in a rapidly escalating conflict that has seen (among other things) the US government intervene in high-profile corporate transactions and the Chinese government institute its first-ever unified export controls regime.

The new administration coming to Washington seems unlikely to relieve the pressure in the short term: although many of the United States' trade war measures were signature policies of the Trump White House, President-elect Biden has already stated that he does not intend immediately to roll back Trump-era tariffs. Indeed, his foreign policy is broadly expected to recreate many elements of President Obama's (which included, for example, opposition to Chinese naval operations in the South China Sea and support for the Trans-Pacific Partnership as a free-trade alternative to Chinese influence). Furthermore, many anti-China measures (especially those focused on US caution regarding Chinese telecommunications firms and China's purported human rights violations in Hong Kong and Xinjiang) have enjoyed broad bipartisan support in Congress, indicating that the tensions run deeper than US political fault lines.

Away from the United States, in 2020 the EU imposed sanctions on China relating to its actions in Hong Kong; India banned dozens of apps operated by Chinese companies following military confrontations between the two countries high in the Himalayas; and the UK, the Netherlands and others have proposed new or expanded official processes to review foreign direct investments for potential national security concerns. Trade controls like these will likely continue to proliferate on a global scale, requiring well-informed and globally coordinated strategies to mitigate the risks they present.

The dynamism of the United States–China dispute has spread to other US sanctions and trade agendas as well, with 2020 witnessing new forms of sectoral sanctions targeting Venezuela, heightened tensions with Russia (especially regarding cyber, military, intelligence and energy export issues), and the Trump White House's "maximum pressure" campaign against Iran. A Biden White House seems primed to change course on some – but not all – of these priorities – for example, President-elect Biden has publicly repudiated President Trump's rejection of the Iran nuclear deal and has committed to lift some Iran-related sanctions in exchange for Iran's return to compliance with the deal. He has also indicated a willingness to revisit Obama-era rapprochement with Cuba. On the other hand, President-elect Biden has taken strong anti-Russia positions in the past. He and his key advisers, including Secretary of State nominee Tony Blinken, played a central role in the US response to Russia's

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2014 annexation of Crimea, while during his time out of office Biden also served on an international commission dedicated to fighting Russian influence in Western elections. He has supported the recognition of Juan Guaidó as Venezuela's legitimate leader and has criticized what he characterizes as President Trump's misdirected focus on opposing the Maduro regime (rather than resolving the humanitarian crisis on the ground). However, President-elect Biden still espouses the use of "intelligent" and multilateral sanctions to lead to new elections and the release of political prisoners.

2021 may also feature continuing intersections between sanctions and trade issues, international investigations and corporate compliance risks. This trend enjoyed a significant profile in 2020, with the US Department of Justice using its criminal prosecution authority to pursue a "China Initiative" targeting Chinese corporate misconduct in the United States, while the US Securities and Exchange Commission fielded proposals to increase its oversight of US-listed, China-based companies. Away from China, US criminal authorities resolved an expansive foreign corruption and military export controls case alongside their counterparts in Europe. From a sanctions policy perspective, the crossover and globalization of issues in 2020 saw the EU and the UK join the United States, Canada and the Baltics in adopting a global Magnitsky-style sanctions program, making bribery, corruption or human rights violations anywhere in the world a basis for imposing sanctions.

Overall, the sanctions and trade arena promises to remain a highly fraught, quickly changing battleground in 2021 – one in which it may prove increasingly difficult for international businesses to sell, move money and make new deals across borders.

Prospects for tax reform under the Biden administration

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President-elect Joe Biden has proposed changes that are estimated to increase tax revenue by $2.1tn over the next 10 years. However, whether these reforms will be enacted into law will be determined to a large extent by which party holds a majority in the Senate after the run-off elections in Georgia. Any changes to US tax law could come into effect in 2021, but are more likely to occur in 2022.

Under the Biden proposals, well-paid individuals will face higher income and payroll taxes, while low- and middle-income individuals may benefit from expanded tax credits. For high-income individuals, the most important proposals in the plan include:

- a repeal of the 2018 tax cuts for individuals earning more than $400,000, increasing the marginal rate for these individuals back to 39.6 percent (from the current 37 percent) plus the 3.8 percent Medicare tax;
- imposing a 12.4 percent (combined employer/employee) social security payroll tax on wage and self-employment income above $400,000 (this tax currently does not apply to wage or self-employment income over $137,700);
- taxing capital gains and dividend income at ordinary income rates for individuals with incomes over $1m;
- a 28 percent cap on the benefit from itemized deductions and reintroduction of the "Pease Limitation" (a 3 percent reduction in itemized deductions per dollar of income above certain income thresholds, which was repealed in 2017); and
- a phase-out of the special "qualified business income" deduction for business income of individuals earned through partnerships and sole proprietorships (which has reduced the effective rate to about 30 percent) for individuals earning over $400,000.

Taken together, the increase in the marginal tax rate to 39.6 percent and the imposition of 12.4 percent (combined employer/employee) payroll taxes on incomes over $400,000 increase the effective marginal tax rate on earned income to over 55 percent (plus any state and local taxes). Biden's proposal to tax capital gains at ordinary rates is not fully fleshed out (it calls only for "[a]sking those making more than $1m to pay the same rate on investment income that they do on their wages"). This clearly contemplates an increase in long-term capital gains rates to 39.6 percent, and possibly also subjecting capital gains to 12.4 percent social security payroll taxes. It is uncertain whether Biden would remove the $10,000 limitation on deducting state and local taxes that was implemented in 2017's tax reform.

Corporations also face higher taxes under the Biden proposals. The plan would see the corporate tax rate increase from 21 percent to 28 percent, which would be lower than the 35 percent tax rate in effect prior to the 2017 tax reform but higher than the OECD average of 23.5 percent. Biden also proposes the implementation of a "book tax," a corporate minimum tax equal to 15 percent of a corporation's book income. The 2017 tax reform eliminated the alternative minimum tax for corporations; this move would reintroduce a corporate minimum tax (in addition to the base erosion anti-avoidance tax (BEAT), which effectively imposes a minimum tax on US companies making deductible payments to non-US affiliates).

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For multinational companies, Biden has proposed a doubling of the tax on global intangible low-taxed income (GILTI) of controlled foreign corporations (from 10.5 percent to 21 percent), calculating GILTI on a country-by-country (rather than an aggregate) basis and the elimination of the effective exemption (through a dividends received deduction) for income of controlled foreign corporations attributable to qualified business asset investment (QBAI) (which Biden referred to as a "loophole"). Elimination of the QBAI exemption and doubling the GILTI rate would effectively subject US corporations to current tax on worldwide income, albeit still at a lower rate than the rate on domestic income if the corporate tax rate increases to 28 percent. A return to current tax on worldwide income without an exclusion for returns from tangible assets would be a significant reversal from the changes introduced in 2017, which established a quasi-territorial tax system. The Biden proposals would also impose a 10 percent surtax on services and sales to US customers from a US company's foreign affiliate. It is unclear how this surtax would interact with BEAT.

If the Republicans remain in control of the Senate, it is doubtful that many of Biden's proposals will be enacted into law. There is unlikely to be bipartisan support for raising the corporate tax rate to 28 percent or for making significant changes to the GILTI regime; these proposals would have a significant impact on US corporations' competitiveness globally. If the Democrats control the Senate, there is more scope for changes in tax law – but the Biden administration is nevertheless likely to face a political battle on significant tax increases.

'Caremark' and Section 220 requests

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In last year's board memo we discussed recent trends in Delaware litigation, including the *Marchand* and *Clovis* decisions (which allowed *Caremark* failure of oversight claims to proceed past the pleading stage) and the continued use of Section 220 requests for books and records. Developments in 2020 show these trends will remain relevant to boards as we head into 2021.

'Caremark' litigation

The Delaware Supreme Court's decision in *Marchand v. Barnhill* took many by surprise, given that *Caremark* claims are hard to plead and prove. In 2020, we saw three more Court of Chancery decisions upholding *Caremark* claims at the pleading stage: *Inter-Marketing Group USA, Inc. v. Armstrong*; *Hughes v. Hu*; and *Teamsters Local 443 Health Services & Insurance Plan v. Chou*.

In *Inter-Marketing*, the Court of Chancery permitted a *Caremark* claim to proceed in a derivative action alleging an utter failure to implement or properly oversee a pipeline integrity reporting system, which resulted in a pipeline rupturing and spilling 3,400 barrels of oil into an environmentally sensitive part of the West Coast. In permitting the claim to proceed, the court gave significant weight to trial testimony of the company's CEO in California criminal proceedings in which he testified that pipeline integrity was "not discussed at the board level." In *Hughes*, the court permitted a *Caremark* claim to proceed where the allegations supported an inference of a conscious failure to monitor or oversee operations in connection with the company's financial reporting, which resulted in the restatement of three years of financial statements. In particular, the company's audit committee was alleged to have met sporadically and only when required by the federal securities laws, and their "abbreviated meetings" suggested that they devoted inadequate time to their work, particularly given known internal controls issues. In addition, according to the allegations, the audit committee frequently acted through written consent, as opposed to addressing issues during live meetings, and the company's outside auditor, which was later sanctioned, failed to adequately identify and report key issues relating to the company's financial performance (and when it did, the audit committee failed to follow up or investigate). Similarly, in *Teamsters*, the court sustained another *Caremark* claim, finding sufficient for purposes of a motion to dismiss plaintiff's allegations that the board consciously failed to monitor the company's operations and ignored multiple red flags relating to the company's manufacture and distribution of pre-filled syringes of oncology medications. Specifically, the board was alleged to have ignored a negative assessment from outside counsel regarding the company's compliance program, a *qui tam* suit was presented to management but never reported to the board, and a DOJ subpoena and FDA search warrant were not discussed by the board.

When analyzed together with *Marchand* and *Clovis*, we can see some common themes continuing to develop. It is becoming clearer that the alleged failure of oversight relating to "mission critical" risks is what separates the

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successful *Caremark* claim from the unsuccessful one, at least for purposes of surviving a motion to dismiss. These recent cases make it all the more critical for board minutes and other corporate records to meticulously document each of the steps the board has taken in exercising its duty of oversight. Indeed, the post-*Marchand* cases have reaffirmed the importance of Section 220 requests in successfully pleading *Caremark* claims, and courts appear to be more willing to permit claims to pass the pleading stage where the board records do not clearly reflect a diligent board following up on red flags.

Section 220 demands

It is thus not surprising that we continue to see a rise in the use of pre-litigation Section 220 demands. The scope of available documents varies by court, and Courts of Chancery continue to distinguish between formal board materials (e.g., minutes, other board-level documents that evidence deliberations and decisions) and informal board materials (e.g., emails, texts and other communications), with the former being routinely discoverable and the latter typically (though not always) available only upon a proper showing by the plaintiff.

In addition, several issues related to Section 220 demands that were raised *in dicta* in the Court of Chancery's decision in *Juul Labs, Inc. v. Grove* could lead to additional litigation in the future. First, the court questioned whether the internal affairs doctrine would bar a stockholder from bringing an inspection action outside of Delaware, setting up the possibility that a stockholder could use the inspection statutes of a non-chartering jurisdiction to obtain books and records. Since many companies are chartered in Delaware but have their principal places of business elsewhere, this option could become a frequent tool of prospective plaintiffs seeking a more favorable forum. Second, the court noted that while Delaware courts have historically rejected companies' efforts to limit or eliminate inspection rights, there were "strong countervailing considerations" in favor of allowing such waivers, "including Delaware's broad recognition of parties' ability to waive other important rights, whether constitutional or statutory." The court suggested that one relevant factor in determining the viability of a waiver of inspection rights was whether it appeared in a unilateral or bilateral agreement, with the latter being more likely to survive scrutiny. As *Juul Labs* will not be the last word on either of these issues, further developments are expected.