



Corporate Governance Hot Topics (and Not Topics)

September 17, 2024

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Corporate Governance Topics for Today

Hot Topics

- Corporate transparency
- Artificial Intelligence and emerging technologies
- Cybersecurity
- Environmental conscientiousness and reporting
- Corporate DEI initiatives
- Executive compensation
- Politics
- Ascending shareholder proposal trends

Not Topics

- State of incorporation
- Prioritization of short-term financial success
- Hostile takeovers
- Descending shareholder proposal trends

Board of Directors

- Sets strategic direction of the company
- Oversees management team—ensures the right people are responsible for the right things
- Fiduciary duties
 - Duty of care
 - Duty of loyalty
 - Protected by business judgment rule

Management – day-to-day operations

Shareholders – owners of company; limited but expanding role

- The limits of shareholder control over the board of directors have been tested recently in Delaware, most notably in *W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.*

- **Must consider maximizing profits in the interests of company's shareholders:**
 - Core of board's fiduciary duties
 - Traditionally considered only stakeholder the board should consider

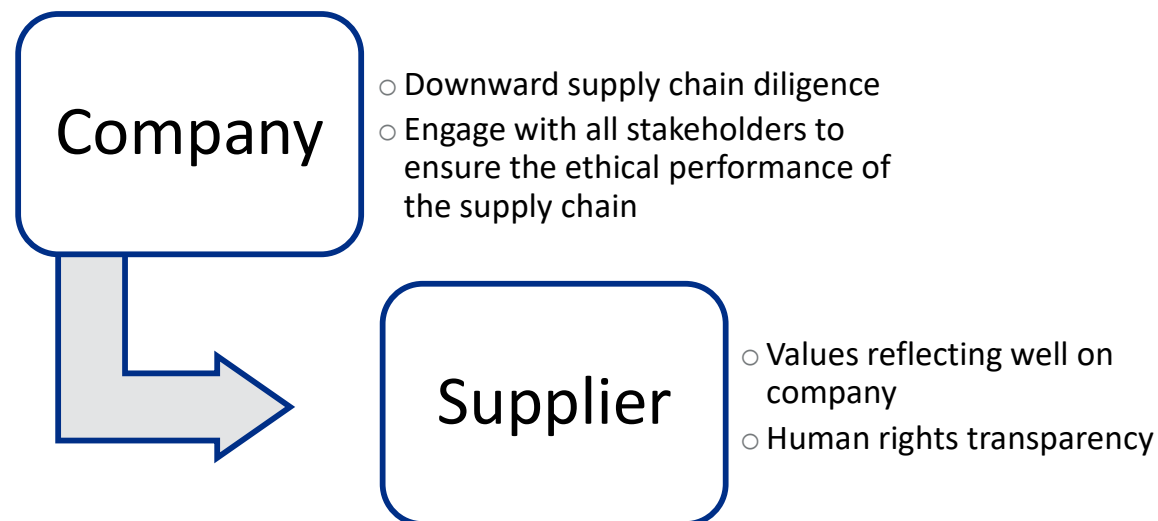
- **Continued movement toward considering other stakeholders:**
 - Society generally, the environment, affected communities
 - Delaware: Board may consider other stakeholders to the extent they bear on interests of company and shareholders – open debate as to where line is drawn
 - Some states have codified the permissibility of the board to consider external stakeholders under the duty of care (see, *e.g.*, Pennsylvania Business Corporation Law §515(a) and Ohio General Corporation Law §1729.23(D))

Corporate Governance Hot Topics

- **Most fundamental of all corporate governance topics – promoting corporate transparency** – has been Congress’s and the SEC’s number one goal since the inception of modern corporate governance.
- **Newest development is Corporate Transparency Act:**
 - Went into effect on January 1, 2024
 - For most existing entities, first reporting obligation will be due on January 1, 2025
 - Certain businesses must report beneficial ownership information to Department of Treasury’s Financial Crimes Enforcement Network
 - Many nuanced exemptions
- Boards of public and private companies are responsible not only for complying with these new reporting obligations, but also for setting the company’s direction in terms of disclosure levels and acceptable risks.

Corporate Transparency: Supply Chain

- In recent years, there has been a growing emphasis on supply chain transparency, diligence and ethics. The concept of the “ethical supply chain”—the idea that a company’s supply chain should reflect the values of the company itself—permeates throughout ESG discussions.
- In the United States, this remains primarily a reputational issue. An ethical concern somewhere along the supply chain can cause stakeholder uneasiness, public criticism and even outright boycotting.
- Internationally, legislators have gotten involved. After a series of supply chain due diligence laws were passed by European countries, the EU adopted the Corporate Sustainability Due Diligence Directive in April 2024. The new directive requires companies to take steps to ensure that its entire supply chain complies with certain human rights and environmental protection standards.

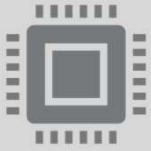


Artificial Intelligence and Emerging Technologies

- In 2024, AI is shaping businesses of every kind and with it corporate governance. While routine AI implementation and use case analysis may fall outside scope of board's duties, boards must use their oversight function to set the aggressiveness of company's AI implementation framework within the context of its industry:



- **AI is becoming more of a regulatory focus in 2024:**
 - **There has been an uptick in mentions of AI in Form 10-Ks filed with SEC.** A recent Bloomberg study estimated that over 40% of S&P 500 companies referenced AI in their 2024 Form 10-K filings.
 - In response, SEC has advised that, although companies should disclose material AI risks, it will crack down on **“AI-washing”** in which AI disclosures are exaggerated or not particularized to the company.



Emerging technologies have and will continue to further fuel cybersecurity threats. Cybersecurity offers a great example of the growing trend of stakeholders' demanding board oversight in areas in which just a decade ago the board's involvement would have been seen as overstepping.



SEC's new cybersecurity rules require public companies to disclose the board of director's oversight of risks from cybersecurity threats. SEC considered a requirement to have a cybersecurity expert on the board, but that requirement did not make it into the final rules.



Although ***private companies are not directly impacted by SEC rules***, their ***stakeholders may have substantially similar demands*** given the current cybersecurity climate.

- Biggest development in 2024 is SEC's new climate disclosure rules, which have been stayed pending judicial review. The rules contain governance provisions that require disclosure of board's climate-related oversight and related governance structure.
- It is the board's responsibility to set the company's direction in complying with this watershed regulation:

Public Companies

- Will be directly subject to the new rules.
- Now is the time to exercise the board's core oversight function of deciding who is responsible for what – a robust internal governance framework is the key to climate disclosure reporting and controls.

Private Companies

- In most cases, private companies will be substantially indirectly affected by the federal climate reporting developments:
 - Private companies in supply streams with public companies will lose business if they cannot report climate disclosures to the public companies.
 - Private equity owners of private companies are under climate disclosure pressures.
 - Bank credit may be increasingly tied to climate disclosures.

- On June 29, 2023, U.S. Supreme Court struck down affirmative action in college admissions in *Students for Fair Admissions v. Harvard*. Over the past year, conservative activists have challenged a variety of corporate DEI initiatives.
- **The legal challenges have sometimes succeeded:**
 - *American Alliance for Equal Rights v. Fearless Fund*
 - Some law firms elected to amend DEI fellowship programs when challenged.
- **In other cases, companies have prevailed:**
 - Pfizer
 - Disney
 - Starbucks
 - Nasdaq
- **The legal landscape remains murky. DEI initiatives at the greatest risk of facing challenges include:**
 - Fellowship or grant programs that are limited to certain ethnic groups.
 - Explicit policies to increase certain participation or membership of underrepresented groups.
 - Explicit policies to favor minority groups in investment decisions.

- **Executive compensation** has been in the news lately as **Elon Musk** tried to defend his \$56 billion compensation package. **Although much of that case is unprecedented, stockholder concerns about compensation are not.**
- Each proxy season, there are shareholder proposals regarding executive and director compensation, and a particular area of focus recently has been golden parachute packages.
- SEC's pay-for-performance rules have continued to heighten the focus on executive compensation with the goal of ensuring that executive compensation packages are actually compensating for performance.
- **The biggest regulatory development in the past year has been new Item 402(x) of Regulation S-K**, which requires, among other things, narrative disclosures regarding policies and practices on timing of option-like compensation in relation to disclosure of material nonpublic information.
 - As with the elimination of tax-deferred treatment of certain performance-based compensation under § 162(m) of the Internal Revenue Code several years ago, we do not expect new Item 402(x) to impact the prevalence of performance-based compensation, but it does underscore the importance of transparency in executive compensation.

- In an election year, it is especially important for companies and their boards to be thoughtful and intentional about their political stances.
- **Rise of consumer backlash events that result in substantial reputational fallout:**
 - Robby Starbuck publicity campaigns against corporate DEI programs
 - Disney LGBTQ support and corresponding feud with Florida
 - Bud Lite transgender promotional campaign
 - Target Pride Month clothing collection
- ***What can a board do to mitigate consumer backlash risks?***
 - Often, these events are caused by statements or decisions made by middle management. However, taking a political position, even in company advertising, is a *strategic* decision. Understand when your board should be informed of a matter and when it should be presented as a matter for decision.
 - There should be a unified external communications approach. Management and the board should both understand what types of matters for external communication should be brought before the board before issuance.

Ascending Shareholder Proposal Trends

- We reviewed a data set of every shareholder proposal submitted to the 250 largest public US companies in each of the past 10 years.

Categories that are trending up:

- Animal welfare
- Charter and bylaws amendments
- Climate change risks
- Code of conduct
- Diversity reporting
- Human rights
- Labor issues
- Greenhouse gas emissions
- Public health
- Racial equity

Categories that have been consistently high:

- Lobbying
- Political contributions
- Independent chair requirements

Corporate Governance Not Topics

- Elon Musk made a major splash this year by shifting both Tesla's and SpaceX's state of incorporation from Delaware to Texas. This spurred a general discussion of whether Delaware remains the best place for a business to incorporate, but that discussion was short-lived:
 - Reasons behind Tesla move will not apply to most companies
 - We have not seen other companies follow suit
- **Traditional reasons to incorporate in Delaware remain as relevant as before:**
 - Well-developed and trusted corporate law
 - Efficient and well-respected Court of Chancery
 - Certain tax benefits
- Any board determination that its jurisdiction of incorporation should change (and ensuing recommendation to shareholders) would require a solid analysis of why such a change is in the best interests of the company and its shareholders.

Prioritization of Short-Term Financial Success

- The subject of much academic interest, there has been a fundamental shift over the past few decades in how boards prioritize short- versus long-term gains.

Then

- It was thought to be a corporation's core mission to maximize shareholders' immediate gains.
- It was the board's duty to provide the shareholders with short-term profits.
- Failure to achieve short-term success was often seen as mismanagement, and intentional deferment of gains could even be considered a violation of fiduciary duties.

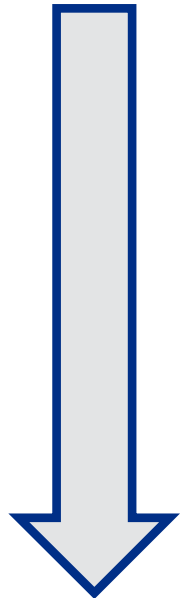
Now

- A board that focuses solely on immediate gains and losses would be deemed myopic.
- Boards are expected to lead their company in a manner that enhances long-term economic prosperity.
- Not only is a long-term perspective not a violation of a director's fiduciary duties, it is *required* under those duties.

- In the 1980s, a rise in hostile takeover attempts prompted a focus on shareholder rights and the board's conflict of interest when faced with a potential takeover.
 - There were some high-profile examples of backroom deals struck by boards to avoid a hostile takeover, followed by a legal effort to afford shareholders better protections.
- Concerns over director's actions when faced with hostile takeover attempts have faded from the spotlight entirely today.
 - Although hostile takeovers themselves have not disappeared entirely today, the law governing the board's actions in such a situation is more well settled now.
 - We more often see activist shareholders seek to influence a company's actions through public engagement up to the threat of a short slate of directors.
 - The rise in independent directors and pay packages that contemplate takeovers ex ante have also helped quell concerns.
- **What has replaced hostile takeovers in corporate governance?**
 - The rise of institutional investors and activist campaigns for change.

Descending Shareholder Proposal Trends

- We reviewed a data set of every shareholder proposal submitted to the 250 largest public US companies in each of the past 10 years.



Categories that are trending down:

- Adopting and amending proxy access
- Shareholder action by written consent
- Threshold for special meetings
- Diversity on the board
- Removing supermajority voting requirements

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