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Corporate Governance 2023

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USA: Law & Practice and Trends & Developments

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USA

Law and Practice

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1. Introductory

1.1 Forms of Corporate/Business Organisations

In the USA, there are three principal forms of business organisations: corporations, partnerships and limited liability companies. Some small-business proprietors do not form a business organisation and therefore operate with no liability shield between the business and its proprietor (sometimes referred to as a sole proprietorship).

Corporations

A corporation is an entity owned by stockholders, managed by a board of directors and established by the filing of a certificate of incorporation or similar filing with the secretary of state of a US state. Corporations can be privately held or publicly traded on a stock exchange, with public corporations having more stockholders. The board of directors typically delegates day-to-day management to the corporation's executive officers while exercising oversight over management. A corporation is liable for the obligations of its business, and its stockholders are generally not held liable for such obligations.

State law typically requires a corporation to hold board meetings and annual stockholder meetings. Although corporations have comparatively less governance flexibility and are subject to certain other disadvantages compared to other entity forms (including entity-level taxation), large and widely held public companies are usually organised as corporations, as they are recognised as the traditional corporate form and tend to be the preferred investment vehicle for investors. Certain states provide for other forms of for-profit corporations, such as public benefit corporations and statutory close corporations.

A public benefit corporation is organised for the purpose of a public benefit rather than for the primary purpose of enhancing stockholder value. Statutory close corporations (which are required to have fewer than a specified number of stockholders) are typically subject to fewer governance formalities than ordinary corporations.

Partnerships

There are two forms of partnerships: general partnerships and limited partnerships. A general partnership is an entity in which two or more persons carry on the entity's business. Although not mandated by state law, sophisticated parties often enter into a partnership agreement to specify the rights and obligations of the partners.

In a general partnership, each partner has the authority to undertake transactions, execute contracts and incur liabilities on behalf of the partnership, and is also personally responsible for the obligations of the partnership. Certain states provide for a limited liability partnership, which is a special type of general partnership. In a limited liability partnership, each partner is only personally responsible for liabilities arising from his or her own conduct on behalf of the partnership.

A limited partnership is an entity with two classes of partners, general partners and limited partners, which is formally established by the filing of a certificate of limited partnership or similar filing with the secretary of state. A general partner manages the day-to-day affairs of a limited partnership and is personally liable for the obligations of the limited partnership. Limited partners are mostly passive investors, and their liability is capped at their investment as long as they do not exert active control over the limited partnership.

State law governing limited partnerships is generally flexible, and the governance of limited partnerships can be customised to the preferences of the contracting parties.

Limited Liability Companies

A limited liability company (LLC) is an entity formed by one or more members by filing a certificate of formation or similar filing with the secretary of state. Similar to a corporation, members of an LLC benefit from limited liability. As with a limited partnership, state law generally permits governance of an LLC to be customised to the parties' preferences in an operating agreement.

1.2 Sources of Corporate Governance Requirements

The principal sources of corporate governance requirements for US companies are state statutory and common law, an entity's organisational documents, federal securities laws and regulations, the stock exchange regulations and influential (but non-binding) non-legal materials, such as proxy advisory firms' guidelines and institutional investor voting policies.

State Law

State law is derived from a state's corporate code and related case law. In the USA, the most common state of incorporation for Fortune 500 public companies is Delaware, which has enacted the Delaware General Corporation Law (DGCL) to govern the affairs of Delaware corporations. The DGCL consists of a set of default and mandatory rules. Incorporators may opt out of the DGCL's default rules in a corporation's organisational documents, but a corporation is required to adhere to the DGCL's mandatory rules.

The expertise of the Delaware judiciary and its active role in the development of corporate case law is a source of perceived advantage for Delaware corporations. Entity forms other than corporations are governed by other statutes and case law under state law.

Organisational Documents

An entity's organisational documents set forth its governance rules. For example, a Delaware corporation is governed by a certificate of incorporation and by-laws, and, in certain circumstances, a stockholders' agreement. A general partnership and limited partnership will be governed by a partnership agreement, and an LLC will be governed by an operating agreement.

Federal Securities Laws

For public companies, the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act), as amended by the Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Act of 2010 (Dodd-Frank), establish certain rules and disclosure requirements pertaining to corporate governance. Historically, the federal securities laws indirectly regulated the corporate governance of public companies through a disclosure regime. However, SOX and Dodd-Frank added substantive corporate governance rules, such as independence requirements for audit committee members.

Proxy Advisory Firms

Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co (Glass Lewis), issue guidelines to advise stockholders of public companies on how to vote their shares on corporate governance matters. Passive institutional investors often vote on corporate governance matters in accordance with such guidelines, as well as their investors' published voting policies. Given the trend towards shares being held passively, these guidelines and policies play a significant role in the governance of public companies.

1.3 Corporate Governance Requirements for Companies With Publicly Traded Shares

The USA has two primary national stock exchanges: the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq). US companies with publicly traded shares are generally required to follow the corporate governance rules and disclosure requirements set forth in the applicable stock exchange rules and the federal securities laws. These requirements are mandatory, although the stock exchanges provide exemptions for certain companies, such as those with a controlling stockholder, limited partnerships, companies in bankruptcy, smaller reporting companies, registered investment companies, and foreign private issuers.

Director Independence

The NYSE and Nasdaq require a majority of a listed company's board of directors to be composed of independent directors, and boards are required to make the affirmative determination as to whether each director qualifies as independent. The NYSE definition of independence requires that a director have no material relationship with the company. Nasdaq's definition of independence turns on whether the director has a relationship that would interfere with the exercise of the independent judgement of the director in carrying out his or her responsibilities. Although these determinations generally require an assessment of all relevant facts and circumstances, each of the stock exchanges also includes bright-line tests that, if satisfied, disqualify a director from being independent.

These tests relate to:

- whether the director or an immediate family member has been employed by or received compensation from the company;
- whether the director or an immediate family member is employed by another company that makes or receives payments above a certain threshold from the listed company;
- whether the director or an immediate family member is employed by the company's auditor; and
- whether the director or an immediate family member is employed by another company where any of the listed company's executive officers serve on the other company's compensation committee.

Executive Sessions

The NYSE and Nasdaq require independent directors to hold executive sessions once and twice a year, respectively, without the presence of management. The NYSE requires disclosure of the name of the presiding director at each executive session or the method by which that presiding director was selected. The NYSE also requires a listed company to disclose the method for interested parties (not just stockholders) to communicate with the presiding director of the executive session or the independent directors as a group.

Composition of Board Committees

The stock exchanges generally require public companies to have three board committees – audit, compensation and nominating and corporate governance. Stock exchange rules and the federal securities laws include extensive rules regarding the composition and responsibilities of these committees.

Audit Committee

Listed companies must have an audit committee with at least three members who are independent under the stock exchange rules and Rule 10A-3 under the Exchange Act. In order to be considered independent under Rule 10A-3 under the Exchange Act, audit committee members must not accept any consulting, advisory or other compensatory fee from the listed company or its subsidiaries, or be affiliated with the listed company or its subsidiaries. In addition, Nasdaq precludes a director who participated in the preparation of the financial statements of the company or its subsidiaries in the past three years from serving as an audit committee member.

The NYSE and Nasdaq require all audit committee members to have a certain level of financial literacy and one member to have a certain level of financial expertise. The NYSE also restricts service on multiple audit committees, providing that if a director serves on the audit committee of more than three public companies, the board must determine that such service would not impair the director's ability to serve effectively on the listed company's audit committee, and the board must disclose that determination publicly.

Stock exchange rules and the federal securities laws specify certain powers and responsibilities of the audit committee, including:

- appointing and overseeing outside auditors;
- establishing procedures for the receipt and treatment of complaints regarding accounting matters;
- authority to engage and pay independent advisers; and
- reviewing related-person transactions.

The NYSE mandates additional responsibilities of audit committees that are not otherwise required by Nasdaq, including:

- annually reviewing the independent auditor's report relating to the auditor's quality control procedures, any quality control issues identified and measures taken to address such issues;
- reviewing and discussing the company's annual and quarterly financial statements with management and the independent auditor;
- discussing the company's earnings press releases and guidance provided to analysts and rating agencies;
- discussing policies with respect to risk assessment and risk management;
- meeting separately and periodically with management, the internal auditors and outside auditors;
- reviewing with the independent auditor any audit issues and management's responses to such issues;
- setting clear hiring policies for employees or former employees of the independent auditor; and
- reporting regularly to the board of directors.

The NYSE also requires listed companies to maintain an internal audit function, which may be satisfied by an internal department or an outside third party who is not the independent auditor, and the internal audit function must be overseen by the audit committee. The NYSE and Nasdaq rules also govern what types of matters must be addressed in audit committee charters.

Compensation Committee

Listed companies must have a compensation committee composed entirely of independent directors (subject to a limited exception for Nasdaq companies). Nasdaq requires such a committee to be comprised of at least two members. Boards of NYSE companies must take into account the following factors (in addition to the factors outlined under the Director Independence heading above):

- the source of compensation of a director, including any consulting, advisory or other compensatory fee to be paid by the company to the director; and
- whether the director is affiliated with the company or any affiliate of the company.

NYSE and Nasdaq require listed companies to have compensation committee charters, which must, among other things, include: the duty of the committee to review and approve and/or make recommendations to the board relating to executive officer compensation; and the ability of the compensation committee to retain and pay compensation advisers.

Nominating and Corporate Governance Committee

NYSE requires listed companies to have a nominating and corporate governance committee composed entirely of independent directors. In contrast, Nasdaq permits listed companies to approve director nominations by either a majority of a company's independent directors or a nominating and corporate governance committee composed entirely of independent directors (subject to a limited exception set forth in Nasdaq's rules). The NYSE and Nasdaq rules also have requirements relating to nominating and corporate governance committee charters.

Board Evaluations

NYSE generally requires listed companies to conduct self-evaluations of their boards and their audit, compensation, and nominating and corporate governance committees at least annually. However, the NYSE does not provide specific requirements on how these evaluations should be conducted. Nasdaq does not require its listed companies to conduct a board evaluation.

Ethics and Code of Conduct

Stock exchange rules and the federal securities laws require listed companies to adopt a code of conduct applicable to its directors, officers and employees, addressing matters relating to conflicts of interest, fair dealing, compliance with law and enforcement of the code of conduct. Any waivers of the code of conduct for directors or executive officers are required to be publicly disclosed.

Corporate Governance Guidelines

Any company listed on NYSE must adopt and disclose corporate governance guidelines that address certain matters, including director qualification standards and responsibilities, director access to management and independent advisers, director compensation, director orientation and continuing education, management succession and annual performance evaluation of the board.

2. Corporate Governance Context

2.1 Hot Topics in Corporate Governance

In Delaware, directors and officers of a corporation have fiduciary duties of care and loyalty to the corporation and its stockholders. Other states have adopted constituency statues pursuant to which directors and officers are in certain circumstances permitted to consider the interests of constituents other than stockholders, such as customers, employers, the community, suppliers or creditors.

Duty of Care

The duty of care requires a director to act in an informed and considered manner and take the care that a prudent businessperson would take when considering a business decision. A director should review all material information reasonably available when making a decision on behalf of the corporation and should have sufficient time to review the information in advance of making such a decision. A director should be afforded the opportunity to ask questions of management and outside advisers and should take advantage of this opportunity in the event the director does not understand something or believes there is an omission.

A director is entitled to rely upon information provided by management and outside advisers in satisfying this duty, unless the director has knowledge that the reliance is unwarranted.

Duty of Loyalty

The duty of loyalty requires a director to act in the best interests of the corporation and its stockholders rather than in the director's own self-interest or the interests of some other constituency, such as a particular stockholder. A director should either avoid a conflict of interest or disclose the substance of the conflict to the full board. In Delaware, the duty of loyalty also generally requires directors to make good faith efforts to oversee the corporation's operations through the implementation and monitoring of a board-level system for overseeing critical risks (known as the "Caremark" duty). A recent Delaware case confirmed that the Caremark duty of oversight also applies to officers with respect to matters within their areas of oversight.

Judicial Standards of Review

If directors have discharged their duties of care and loyalty, their decisions will generally be protected by the presumption of the business judgement rule, pursuant to which courts will not rescind an action of the board so long as it can be attributed to any rational business purpose. However, if a plaintiff satisfies the burden of showing that directors failed to discharge the duty of care or the duty of loyalty (such as by showing the existence of a conflict of interest) or satisfies the burden of showing gross negligence or bad faith on the part of directors, the board could lose the protections of the business judgement rule and its actions could be subject to a higher standard of scrutiny from the courts. For example, recent decisions by Delaware courts have demonstrated an increased willingness to permit Caremark duty of loyalty claims to survive the motion to dismiss stage when the directors' failure to oversee the corporation rises to the level of bad faith.

In certain states, including Delaware, courts apply enhanced scrutiny to board actions under certain circumstances, such as a decision to enter into a transaction constituting a change of control of the company or the adoption of a defensive action by the board.

See **4.8 Consequences and Enforcement of Breach of Directors' Duties** and **4.9 Other Bases for Claims/Enforcement against Directors/Officers** for more information about the standards of review and legal implications in connection with fiduciary duty breaches.

2.2 Environmental, Social and Governance (ESG) Considerations

In the USA, there is a significant amount of rulemaking currently underway related to ESG-related disclosures. Although the federal securities laws do not currently mandate any specific ESG-related disclosures, the Securities and Exchange Commission (SEC) is in the process of developing prescriptive disclosure requirements related to certain ESG topics, such as climate change, human capital management and board and workforce diversity. In the absence of such prescriptive requirements, ESG matters are subject to the same principles-based approach and materiality standard that applies to other types of disclosure under the federal securities laws.

Over the last few years, as regulatory rulemaking in this area remained slow, institutional investors, proxy advisory firms, stockholders and other stakeholders have called on companies to provide ESG disclosures and/or enhance their ESG practices through public statements, voting guidelines and stockholder proposals. Stockholder proposals, in particular, generally serve as a low-cost way for stockholders to influence corporate behaviour and, since 2020, the number of stockholder proposals related to environmental and social matters has significantly increased year-over-year.

Additionally, over the last few years, major institutional investors, including BlackRock, State Street and Vanguard, have revised their proxy voting guidelines to highlight a number of key ESG focus areas, including climate change and the transition to a net zero economy, board and workforce diversity, and effective human capital management, each of which is viewed as playing a critical role in long-term company performance. Failure to provide appropriate disclosures and policies related to such issues can result in votes against the company, both on stockholder proposals and in director elections. For a discussion of examples of topical ESG issues, including director qualifications and workers' freedom of association rights, see the USA Trends & Developments chapter in this guide.

On 21 March 2022, the SEC took a major step toward developing a mandatory ESG reporting framework by proposing new rules that would require public companies to provide certain climate-related information in their public reports. Modelled on the framework recommended by the Task Force on Climate-Related Financial Disclosures, the proposed rules would, among other things, require companies to disclose, over a phase-in period, the following:

- how their boards and management oversee, identify and manage climate-related risks and how such risks impact the company (including its financial statements);
- Scope 1 and Scope 2 GHG emissions (and Scope 3, if material); and
- any climate-related targets or goals adopted by the company, including how the company plans to achieve them and relevant data to assess the company's progress.

It is now expected that the SEC will adopt final versions of its climate disclosure rules during the second half of 2023.

To keep pace with the increased focus on ESG issues, companies have increasingly engaged with investors on ESG matters through a broad array of channels, including periodic sustainability reports, enhanced ESG disclosures in proxy statements and other public filings and ESG-related conference calls. As Regulation FD prohibits selective disclosure of material, non-public information, companies may be required to make additional public disclosure on ESG matters in order to satisfy their obligations under Regulation FD.

3. Management of the Company

3.1 Bodies or Functions Involved in Governance and Management

Corporations

In the USA, state law generally delegates the authority to manage the business and affairs of a corporation to a board of directors. A board of directors typically delegates day-to-day management of a corporation to its executive officers while exercising oversight over management. The boundaries of a board's delegation to management may be documented by a board-approved delegation of authority that sets forth what types of decisions and transactions require board approval (such as transactions above a specified threshold).

A board may also delegate certain responsibilities to its committees, including its standing committees and/or new committees established by the board for the purpose of pursuing certain objectives, such as a transaction committee to manage the execution of certain strategic transactions or a special litigation committee to address stockholder derivative litigation. However, because the board as a whole remains responsible for ensuring it is satisfying its fiduciary duties, including its oversight responsibilities, it is important for the board to receive periodic updates regarding material issues it has delegated to management or its committees.

Stockholders do not actively manage the business and affairs of a corporation, but instead exert influence on a corporation by voting, making stockholder proposals, acquiring board seats by nominating directors or settling with the board and publicly or privately communicating to the board and/or management.

Limited Liability Companies

The governance structure of an LLC depends on whether the LLC has one or more members and whether it is managed by its members or managers. A single-member LLC will typically be managed by its sole member. A multi-member LLC may be managed by its members or by outside managers. Freedom of contract is a fundamental principle of US LLCs, so management authority in a multi-member LLC can generally be tailored in the operating agreement to the contracting parties' needs.

Partnerships

In a general partnership, each partner has the authority to undertake transactions, execute contracts and incur liabilities on behalf of the partnership, and is responsible for the day-to-day affairs of the partnership. In a limited partnership, management authority is delegated to a general partner, and limited partners will not have management authority over the business. Similarly to LLCs, limited partnerships follow the freedom of contract principle, so management authority in a limited partnership may also be tailored to the contracting parties' preferences in the limited partnership agreement.

However, limited partners may lose the protection of limited liability if they participate in day-to-day management of the business.

3.2 Decisions Made by Particular Bodies

A board of directors of a corporation in the USA typically makes decisions relating to the following matters:

- mergers and acquisitions;
- charter amendments;
- issuances of securities or equity awards;
- declarations and payments of dividends;
- selection, replacement and compensation of key executives;
- dissolution; and
- other material corporate actions in which there is a determination that board action would be desirable.

Stockholders typically have approval rights under state law or the stock exchange rules for the following actions:

- charter amendments;
- a merger involving the company as a target or a sale of all or substantially all of a company's assets;
- issuance of more than 20% of a company's outstanding shares of common stock;
- conversion to another entity form;
- domestication to a foreign jurisdiction; and
- dissolution of a company.

In an LLC or a partnership, decision-making authority may be tailored to the contracting parties' preferences within certain parameters set forth in the LLC operating agreement or the partnership agreement.

3.3 Decision-Making Processes

A board of directors of a corporation in the USA (including its committees) makes decisions by passing resolutions at a board or committee meeting or by written consent. In advance of a board or committee meeting, management or the board's outside advisers typically provide directors with a meeting agenda and written materials to ensure the directors are properly informed on the topics to be discussed at the meeting. Board meetings often include management presentations on the relevant topics and an executive session in which the board deliberates without the presence of management or any directors that are employed by the corporation.

At the meeting, the secretary of the corporation will typically keep board minutes as the official record of board deliberation and action.

Recent Delaware cases have emphasised the importance of boards adhering to corporate formalities (such as documenting board actions through minutes, resolutions and official letters). For example, stockholders are increasingly making demands in reliance on Section 220 of the DGCL, which gives stockholders the right to inspect a corporation's books and records for certain purposes, in order to gather information to criticise a company's decisions and decision-making processes in advance of filing lawsuits or launching activist campaigns. Under these cases, companies that observe formalities can generally satisfy a Section 220 demand by producing those formal records only. However, companies that instead correspond through informal channels (such as emails and text messages) may need to produce those electronic communications.

Stockholder action may be taken at annual or special meetings or, if permitted by applicable state law and the company's organisational documents, by written consent. See **5.3 Shareholder Meetings** for more information about stockholders' rights to call special meetings or act by written consent.

In an LLC or a partnership, action may be taken at meetings or by written consent, as may be set forth in the LLC operating agreement or the partnership agreement. There is generally no requirement to hold meetings.

4. Directors and Officers

4.1 Board Structure

A typical board structure for a US company is a single class of directors elected annually with standing committees that are delegated authority by the board to be responsible for certain matters such as audit, compensation and corporate governance matters. The board's authority to delegate matters to committees is typically broad, and committees will generally have the full authority to exercise the power of the board, subject to limited exceptions.

Most directors in the USA are elected annually. However, many states, including Delaware, permit boards to be staggered into separate classes that are up for election less frequently than annually, with each class generally limited to a term of no longer than three years. As a result, stockholders of companies with staggered boards only elect a portion of the board each year (eg, a third of the board). Staggered boards have become less common among US public companies, largely due to opposition from proxy advisory firms and institutional investors who argue that such structures diminish director accountability to stockholders and promote entrenchment. See **4.4 Appointment and Removal of Directors/Officers** for more information regarding the election of directors.

4.2 Roles of Board Members

A board of directors of a public company is typically comprised of management directors (ie, directors who also serve as employees or officers of the company) and independent directors. However, there may be other directors who are not independent but also not management directors (eg, directors who are employed by a controlling stockholder of the company). See **1.3 Corporate Governance Requirements for Companies with Publicly Traded Shares** for a discussion of how the independence of directors is determined.

Management directors generally have more intimate knowledge of the corporation's affairs as compared to independent directors. Certain states hold management directors to a higher standard of care due to their knowledge of and active involvement with the business. Independent directors are generally permitted to rely, within reasonable limits, on information provided by management and outside advisers in satisfying their fiduciary duties.

The board will also appoint a chair from amongst its members to generally serve as the leader of the board. The chair can either be an independent director or a non-independent director. When the chair of the board is non-independent (such as the CEO of the company), public companies generally appoint a lead independent director that has similar responsibilities as the chair to help ensure independent oversight of management. The specific responsibilities of the board's chair are typically laid out in the company's corporate governance guidelines or other organisational documents, but usually include duties such as presiding at board and stockholder meetings, establishing meeting schedules and agendas, serving as liaison between the board and management and being available, as needed, to meet with stockholders. In addition to the board chair, the board also appoints chairs of each board committee.

Investors are increasingly focused on directors having a diversity of expertise to enable them to serve as effective board and committee members and make informed decisions regarding the management of the corporation. Although there are limited requirements on the specific skills and qualifications directors must have, stockholders have submitted a number of proposals over the last few years seeking the representation of specific skills on the board, such as environmental, cybersecurity, human rights or corporate governance experts.

To highlight the skills and experiences represented on their boards, public companies are increasingly publishing board skill matrices in their proxy statements that identify which directors possess certain key skills such as finance and accounting, international, risk management and cybersecurity/technology expertise. Rather than providing skills matrices, some companies prefer to disclose only aggregated data that shows the number of directors that possess each skill (without identifying which specific directors qualify).

4.3 Board Composition Requirements/Recommendations

Composition requirements of US boards are driven by stock exchange rules, federal securities laws, state law, and proxy advisory firm guidelines.

Stock Exchange Rules

Subject to certain exceptions, both the NYSE and Nasdaq rules require a majority of a public company's board to be independent, and only independent directors may serve on the audit, compensation and/or nominating and corporate governance committees. The NYSE and Nasdaq have bright-line tests relating to whether a director qualifies as independent, which must be affirmatively determined by the board. See **1.3 Corporate Governance Requirements for Companies with Publicly Traded Shares** for a detailed discussion of the NYSE and Nasdaq requirements on director independence. Nasdaq rules now also require each listed company to (a) publicly disclose board-level diversity matrices and (b) have, or explain why it does not have, at least one director who self-identifies as female, an under-represented minority or as LGBTQ+ by 2023, and two such directors by 2025.

Federal Securities Laws

The federal securities laws require each member of an audit committee to be independent and provide an overlay of independence requirements for audit committee members. See **1.3 Corporate Governance Requirements for Companies with Publicly Traded Shares** for a discussion of independence requirements under Rule 10A-3.

State Law

State law typically does not require directors to be independent. Having independent directors, however, may be favourable to a company and its directors from a stockholder litigation perspective. For example, in the context of a conflicted corporate transaction (ie, a transaction in which an officer or director has an interest on both sides of the transaction), review and approval (or ratification) by disinterested directors (along with the implementation of other procedure protections, such as stockholder approval) may subject such a transaction to a more deferential standard of review by the courts.

Proxy Advisory Firms Guidelines

The proxy advisory firms have published extensive guidelines that relate to board composition. ISS guidelines stress board independence, the existence of audit, compensation and nomination committees composed of independent directors and establishing leadership positions for independent directors, including as board chairs. ISS and Glass Lewis have also adopted board diversity policies in their proxy voting guidelines that generally provide for negative vote recommendations against the chair of the nominating and corporate governance committee of companies that fail to maintain a specified level of board diversity (either in terms of gender or racial/ethnic diversity). The specific minimum diversity thresholds differ between ISS and Glass Lewis, with Glass Lewis generally imposing a higher threshold.

4.4 Appointment and Removal of Directors/Officers

Directors of US public companies are typically elected by a majority of the stockholders entitled to vote at a meeting (although some companies may have plurality voting depending on state law and the company's organisational documents). In majority voting, a nominee generally must receive more “for” votes than “against” votes to be elected (or re-elected) to the board. In plurality voting, the nominees who receive the most “for” votes are elected (or re-elected) to the board until all board seats are filled. For companies that use plurality voting, in an uncontested election, where the number of nominees and available board seats are equal, every nominee is elected upon receiving just one “for” vote.

In the event of a vacancy or a newly created directorship, a majority of directors then in office are generally permitted to fill that vacancy or newly created directorship unless otherwise provided by the corporation’s organisational documents. Typically, stockholders may remove a director with or without cause by a majority vote of stockholders, unless the board is staggered or the corporation has cumulative voting. If the board is staggered, a director may only be removed for cause unless otherwise provided for in its certificate of incorporation.

Officers are appointed by the board or other governing body of the corporation, and the offices of a corporation are typically set forth in the corporation’s by-laws or in board resolutions. An officer may be removed by the board with or without cause, subject to contractual protections in that officer’s employment agreement.

4.5 Rules/Requirements Concerning Independence of Directors

See **1.3 Corporate Governance Requirements for Companies with Publicly Traded Shares** and **4.3 Board Composition Requirements/ Recommendations** for a discussion of rules and requirements relating to director independence.

The federal securities laws and state law provide rules relating to director conflicts of interest. Under the federal securities laws, public companies are required to disclose any transaction over USD120,000 that has occurred since the last fiscal year or is currently proposed, in which the company is a participant and any related person (defined to include directors) has or will have a direct or indirect material interest. Whether a director’s interest in a transaction is “material” is a fact-specific determination; however, the federal securities laws do provide a number of “per se immateriality standards”, including if the director’s interest arises solely from the director’s position as a director at the other company and/or ownership of less than 10% of either company’s stock. The federal securities laws also mandate the disclosure of a company’s internal related-party transactions policies and the directors responsible for applying such policies.

Under state law, conflicted transactions may be voidable and/or subject to a duty of loyalty claim by a stockholder. However, most states have adopted safe harbour statutes for conflicted transactions, which provide that such transactions are not per se voidable if the material facts relating to the conflict are disclosed to the board, the transaction is approved by non-conflicted directors or stockholders and/or the transaction is fair to the company. A company will also be in a better position to defend a stockholder’s duty of loyalty claim if it takes any or all of the steps outlined in the preceding sentence.

4.6 Legal Duties of Directors/Officers

See **2.1 Hot Topics in Corporate Governance**.

4.7 Responsibility/Accountability of Directors

In Delaware and many other states, directors and officers owe fiduciary duties to the corporation as an entity and to its stockholders. See **2.1 Hot**

Topics in Corporate Governance for more information regarding general fiduciary duties. In the case of insolvent corporations, that duty requires directors and officers to manage the company for the benefit of all residual beneficiaries, and creditors of insolvent companies may enforce these fiduciary duties against directors.

Certain other states have various forms of constituency statutes, which permit the board in certain circumstances to balance the interests of stockholders against interests of other constituents, including customers, employers, suppliers or creditors. In addition, directors of public benefit corporations are required to consider the interests of the public, not just those of the stockholders.

4.8 Consequences and Enforcement of Breach of Directors' Duties

Fiduciary duty claims against a director may be claims brought directly by the corporation or by its stockholders on behalf of the corporation or, in some instances, on their own behalf. The consequences of a breach of fiduciary duty may be monetary damages or equitable relief.

A director is typically protected from personal monetary liability arising out of duty of care claims in several ways.

Firstly, courts typically apply the business judgement rule when reviewing the business decisions of a director. Because this standard of review is highly deferential to the board, it is rare for a court to find a fiduciary duty breach in decisions subject to the business judgement rule. (Note that duty of loyalty claims are generally subject to a heightened standard of review in the absence of the satisfaction of certain requirements, which means such claims are more likely to result in liability for directors.)

Secondly, states typically permit corporations to adopt provisions in their organisational documents that provide for the exculpation and/or indemnification of directors for losses and expenses incurred in connection with a duty of care claim. Indemnification rights generally apply to officers as well, and recently adopted amendments to the DGCL now permit companies to exculpate certain senior officers in connection with direct duty of care stockholder suits (but not for claims brought by the company or derivative suits). However, state corporation law statutes generally preclude companies from exculpating and/or indemnifying duty of loyalty claims.

Thirdly, states typically permit corporations to purchase liability insurance for their directors to cover losses resulting from fiduciary duty claims, including duty of care and loyalty claims.

4.9 Other Bases for Claims/Enforcement Against Directors/Officers

Courts evaluate board action under different standards of review, depending on the facts and circumstances underlying the board action. As discussed in **2. Corporate Governance Context**, business judgement review is the default standard for courts to review board action. If a plaintiff satisfies the burden of rebutting a presumption underpinning the business judgement rule, courts in most states apply "entire fairness", the most onerous standard of review, to board action, which requires the board to establish that a transaction was a product of fair dealing and fair price.

Courts in certain states, such as Delaware, apply enhanced scrutiny (which is an intermediate standard of review) to board action in certain circumstances, regardless of whether the presumptions underlying the business judgement rule have been satisfied, such as a board's decision to enter into a transaction constituting a change of control of the company or to adopt a defensive action, such as adopting a poison pill. In circumstances where enhanced scrutiny applies, boards are required to take certain actions that they would not otherwise be required to take, such as seeking a transaction offering the best value reasonably available to stockholders in a change-of-control scenario.

Breaches of Corporate Governance Requirements

In addition to the core fiduciary duties of care and loyalty, Delaware and many other states recognise certain other corporate law doctrines supporting claims against directors or officers for breaches of corporate governance requirements. For example, in Delaware, board action intended primarily to interfere with the stockholder "franchise" – ie, core rights incident to share ownership, such as voting rights – must be justified by demonstrating a compelling justification for taking such action. Another example is the corporate waste doctrine, under which directors have a duty not to approve a "wasteful" transaction, which no person of ordinarily sound business judgement would find fair or acceptable.

Delaware law also imposes on directors a duty to disclose all material information in certain circumstances, including self-dealing transactions.

For a discussion of limitations on director and officer liabilities, see **4.6 Legal Duties of Directors/Officers**.

4.10 Approvals and Restrictions Concerning Payments to Directors/Officers

Compensation for executive officers and directors is generally determined by the board of directors, and this responsibility is often delegated to compensation committees (or nominating and corporate governance committees, in the case of director compensation). In Delaware, the board's decisions regarding executive compensation are protected by the more deferential business judgement rule. A conflict of interest resulting in application of the entire fairness standard (which often survives a motion to dismiss) may arise where directors approve compensation arrangements for themselves.

The federal securities laws require a public company to convene a stockholder vote to approve the compensation of the company's named executive officers (generally, the CEO, CFO and three other most highly compensated executive officers), commonly referred to as the "say-on-pay" vote, at least once every three years and a separate vote to determine how often the say-on-pay vote will be held ("say-when-on-pay") at least once every six years.

The NYSE and Nasdaq listing standards require listed companies to receive stockholder approval for most equity compensation plans (and material amendments thereto).

4.11 Disclosure of Payments to Directors/Officers

The federal securities laws require extensive disclosure regarding the compensation of executive officers and directors in a public company's proxy statement. The disclosure focuses on compensation for the company's named executive officers (as described in **4.10 Approvals and Restrictions Concerning Payments to Directors/Officers**); however, additional executives may be included in this group because of turnovers during the applicable year.

The company's Compensation Discussion and Analysis (CD&A) in its annual proxy statement must explain the material elements of the company's compensation for its named executive officers and is intended to facilitate investors' understanding of the numbers in the requisite tables that follow the CD&A. A short compensation committee report is also required to be included in the proxy statement. Disclosure of any policies or practices regarding the ability of employees and directors to engage in hedging transactions with respect to the company's securities is also required.

Summary Compensation Table

The main table required to be included in a company's proxy statement is the Summary Compensation Table, which generally discloses the compensation earned by each named executive officer for each of the prior three fiscal years by category: salary, bonus, stock awards, options awards, non-equity incentive plan compensation, change in pension value and non-qualified deferred compensation earnings, other compensation and total compensation. The SEC's new "pay-for-performance" rules also require companies to include a table containing specific executive compensation and financial performance measures for the five most recent fiscal years as well as narrative disclosure explaining the relationship between the compensation paid to each named executive officer and the performance of the company. Other required tables must include information relating to grants of equity and bonus awards made to each named executive officer in the last fiscal year, outstanding equity awards at the end of the last fiscal year, stock options exercised by the named executive officers and stock awards that have vested during the last fiscal year, pension benefits, and non-qualified deferred compensation. Narrative or tabular disclosure regarding the circumstances in which a named executive officer may be entitled to compensation upon termination of employment or in connection with a change in control, including estimates of potential payouts is also required.

Companies must also disclose the ratio between the CEO's annual total compensation and the median of the annual total compensation of all other employees.

Director Compensation

Director compensation for the most recent fiscal year is also required to be disclosed in a table that is similar to the Summary Compensation Table, along with related narrative disclosure.

5. Shareholders

5.1 Relationship Between Companies and Shareholders

Stockholders are the owners of a corporation. This ownership relationship is governed by state law. If the corporation is public and listed on a stock exchange, this relationship will also be governed by stock exchange rules and the federal securities laws. Some corporations (but few public companies) may also have stockholder agreements in place that impose additional rights or restrictions on stockholders.

5.2 Role of Shareholders in Company Management

Under state law, stockholders have no involvement in the management of a corporation, which is vested in a board of directors and often delegated to executive officers by the board. State law generally enumerates certain actions that require stockholder approval, which is further discussed in **3.1 Bodies or Functions Involved in Governance and Management**.

5.3 Shareholder Meetings

Annual meetings of stockholders of a corporation are generally required under state law for the election of directors. For example, in Delaware, if a corporation fails to hold its annual meeting 30 days after the date designated for the annual meeting or 13 months after its last annual meeting, the Delaware Court of Chancery may order a stockholder meeting upon the application of any stockholder or director. Special meetings of stockholders may be called by the board of directors or any other person authorised by a corporation's organisational documents, such as stockholders. Corporations may explicitly prohibit the ability of stockholders to call special meetings in their organisational documents as a defence against stockholder activism. Most companies that permit stockholders to call special meetings impose certain procedural requirements in their organisational documents that restrict such a right (such as ownership thresholds, informational requirements and blackout periods). Such restrictions are contained in the company's certificate of incorporation or by-laws.

State law governs the mechanics of holding a stockholder meeting. In Delaware, the location and time of annual meetings may be established in a corporation's organisational documents or by the board. Such meetings can also be held virtually (by means of remote communication) if permitted by the company's organisational documents. Written notice of a meeting must be given to stockholders entitled to vote no later than ten days and no earlier than 60 days before the date of the meeting. The board is required to fix a record date for the purpose of establishing which stockholders are entitled to notice and the right to vote at a stockholder meeting, which must be no later than ten days and no earlier than 60 days before the date of the meeting.

Quorum requirements may be set in a corporation's organisational documents but may not be less than one third of the shares entitled to vote at the meeting. Delaware law generally does not govern the type of business to be conducted at a stockholder meeting, but corporations may include rules in their organisational documents or publish rules and/or agendas. For example, it is common for public companies to adopt advance notice by-laws, which require stockholders wishing to nominate a director or make a stockholder proposal to satisfy rigorous procedural and substantive requirements in order for their nomination or proposal to be properly raised at a stockholder meeting.

In Delaware, stockholders may take action by written consent without holding a stockholder meeting unless prohibited by the corporation's certificate of incorporation. Most public company certificates of incorporation prohibit stockholder action by written consent.

5.4 Shareholder Claims

A stockholder may file (a) direct claims against the corporation or its officers and directors for actions that directly harm the stockholder or (b) derivative claims against the corporation's officers and directors for actions that harm the corporation. A common example of a derivative claim brought by a stockholder is a claim alleging a breach of fiduciary duty by the board.

Prior to filing a derivative claim, a stockholder must demand that the board pursue the claim or, in most states, including Delaware, demonstrate that such a demand is futile because of the board's disinterest or conflict of interest with respect to the litigation. This procedural requirement does not exist for direct claims, so stockholders at times try to refashion derivative claims as direct claims.

5.5 Disclosure by Shareholders in Publicly Traded Companies

Federal Securities Law

The federal securities law requires an investor or group of investors who acquire beneficial ownership of more than 5% of a public company's voting equity securities to file reports relating to their ownership on Schedule 13D, or if eligible, on Schedule 13G. Passive investors that own less than 20% of a company's equity securities are eligible to report that ownership on Schedule 13G and are otherwise subject to a less onerous reporting regime than that applicable to Schedule 13G filers. An investor who acquires more than 5% of a public company's voting equity securities, and is not eligible to file a Schedule 13G, must report the acquisition on a Schedule 13D with the SEC within ten days of crossing the 5% threshold.

Schedule 13D requires the disclosure of the identity of the investor, information about the investor's ownership of the company's securities and sources of funds, any of the investor's arrangements with respect to securities of the company and the purpose of the acquisition, including any plans or proposals which the investor may have to make changes to the board or management or to consummate a corporate transaction. The Schedule 13D must be amended promptly as a result of any material changes in the disclosure to the original Schedule 13D, which include the acquisition or disposition of 1% or more of the class of equity securities of the company. Subject to certain exceptions, an investor eligible to file a Schedule 13G must file the report within 45 days after the end of the calendar year in which the investor first became obliged to make such a filing.

On 10 February 2022, the SEC proposed new disclosure rules that would, among other things:

- shorten the filing deadlines for Schedule 13D and 13G filings to five days from the date the investor crosses the 5% threshold;
- expand the definition of beneficial ownership to cover certain cash-settled derivative securities; and
- broaden the "group" concept pursuant to which securities owned by multiple individuals can be aggregated by clarifying that there does not need to be an express or implied agreement between two individuals for them to qualify as a "group".

Institutional Investment Managers

Institutional investment managers that have assets under management of at least USD100 million must report to the SEC their holdings of exchange-traded equity securities, certain equity options and warrants, shares of closed-end investment companies and certain convertible debt securities on Form 13F within 45 days of the end of each calendar quarter. Form 13F requires disclosure of the name of the manager, the name and class of security holdings and the number of shares and the market value of such shares as of the end of the calendar quarter.

Beneficial Owners

Beneficial owners of more than 10% of any class of equity security of a public company (as well as directors and officers) must report their beneficial ownership of equity securities on Section 16 forms. Transactions in equity securities by such stockholders, directors and officers must generally be reported within two business days. These parties may be required to disgorge to the company any profits made in connection with the purchase and sale of company securities within a six-month period.

Acquisitions of Voting Securities

Certain acquisitions of voting securities by an investor must be reported to the Federal Trade Commission (FTC) and the Department of Justice (DOJ) prior to consummation if the transaction value and the sizes of the investor and issuer exceed certain thresholds pursuant to the Hart-Scott-Rodino Antitrust Improvements Act. Upon the investor making the filing, the FTC and DOJ have a 30-day period in which to request further information from the investor to determine whether the acquisition violates the US antitrust laws.

The contents of the filing are confidential. Stockholders should be mindful of other regulatory regimes that may be implicated by a stockholder's acquisition of shares, including:

- the Committee on Foreign Investment in the United States for certain acquisitions by foreign persons;
- the Federal Energy Regulatory Commission for acquisitions of the shares of regulated utilities; and
- the Federal Communications Commission for acquisitions of the shares of regulated telecommunication companies.

6. Corporate Reporting and Other Disclosures

6.1 Financial Reporting

The federal securities laws require public companies to file publicly annual, quarterly and current reports relating to the occurrence of certain events material to stockholders. Annual and quarterly reports must be certified as accurate and complete by a company's CEO and CFO. Public companies are also required to file proxy statements in connection with their stockholder meetings.

6.2 Disclosure of Corporate Governance Arrangements

The federal securities laws require public companies to disclose the following information relating to corporate governance in their proxy statements:

- director biographical and qualification information;
- director independence and the methodology for determining director independence;
- board meeting attendance and related policies;
- committee information, including membership, purpose and function, and number of meetings held;
- board leadership structure;
- description of the board's role in company risk oversight;
- applicable hedging policies regarding director ownership of stock;
- code of ethics or rationale for non-adoption;
- compensation of the named executive officers;
- compensation discussion and analysis;
- certain pay ratios and say-on-pay policies; and
- independent auditor information.

Public companies must also disclose the occurrence of certain events in a current report, including:

- a change in control;
- the election or departure of a director or officer;
- any amendment to a company's certificate of incorporation or by-laws;

- any amendment to a company's code of ethics, or waiver of a provision of the code of ethics;
- submission of matters to a vote of security holders;
- stockholder director nominations; or
- changes in a company's certifying accountant.

The federal securities laws also require a public company to post on its website its nominating committee, audit committee and compensation committee charters or include the charters as an appendix to its proxy statement every three years. NYSE requires listed companies to make its code of business conduct and ethics publicly available on or through its website.

6.3 Companies Registry Filings

State law generally requires corporations and certain other entity forms to file the charter for a corporation with the Secretary of State. Certain states also require corporations and certain other entity forms to file annual or biannual reports, which generally require basic information about the entity, such as its legal name, address, registered agent and names of directors and officers. States typically make these filings publicly available.

7. Audit, Risk and Internal Controls

7.1 Appointment of External Auditors

The federal securities laws require public companies to have an independent auditor review their financial statements and disclosures and provide an opinion as to their fairness and compliance with the Generally Accepted Accounting Principles (GAAP).

The SEC considers the independence of an auditor impaired if the auditor is not, or if a reasonable investor with knowledge of all attendant facts and circumstances would conclude that the auditor is not, capable of exercising impartial judgement on all issues encompassed within the audit engagement. In addition, certain actions and arrangements between a company and its outside auditor are not permitted, including contingent fee arrangements, direct or material indirect business arrangements between a company and its outside auditor and a company hiring certain employees of the independent auditor during a one-year cooling-off period.

SEC rules prohibit independent auditors from providing certain non-audit services to a company, including but not limited to bookkeeping, management or human resource functions or legal services and unrelated expert advice. Independent auditors may provide other non-audit services to a company that are not specifically prohibited by SEC rules as long as the audit committee provides pre-approval. A company's audit committee is responsible for the oversight of its independent auditor.

7.2 Requirements for Directors Concerning Management Risk and Internal Controls

The federal securities laws require a public company to maintain adequate internal controls over financial reporting (ICFR) in order to provide reasonable assurances with respect to the reliability of the company's financial reporting and compliance with GAAP measures. A company's principal executive and financial officers are responsible for the design and implementation of the internal ICFR regime and must report control deficiencies and related findings to the audit committee and the company's independent auditor. Subject to certain exceptions, companies are required to include a management-drafted internal control report with their annual report and a related attestation by the company's independent auditor.

NYSE requires a company's audit committee to discuss policies with respect to risk assessment and risk management, but states that the audit committee is not required to be the sole body responsible for risk oversight. Federal securities laws only require disclosure of the board's role in the company's risk oversight process. However, in response to investor, proxy adviser and stakeholder pressure, corporate disclosures about risk oversight, particularly in proxy statements, have become increasingly detailed, often including descriptions of the risk oversight processes of specific, critical risks facing the company (such as cybersecurity, environmental and social risks) and/or describing the number of directors the company has that have risk oversight experience.

Trends and Developments

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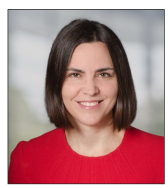

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Caremark Duties of Corporate Officers

Corporate governance reforms continue to be an important topic for US companies. This article will cover the key topical issues in early 2023.

Over the last few years, there has been a series of Delaware cases focused on the duty of oversight, often referred to as Caremark duties, which require directors, in order to satisfy their duty of loyalty, to make good faith efforts to oversee their company's operations by implementing board-level oversight and monitoring of critical risks facing the company. Caremark cases are typically brought by shareholders after a significant adverse corporate event and allege that the event occurred because the company's directors failed to fulfil this oversight duty.

In late January 2023, the Delaware Court of Chancery issued a decision in holding for the first time that officers, in addition to directors, owe a Caremark duty of oversight. Shareholders of McDonald's sued the former head of the McDonald's human resources function for breaching his fiduciary duties by allowing a corporate culture to develop that condoned sexual harassment and misconduct. Specifically, the shareholders alleged that the officer breached a Caremark duty by consciously ignoring "red flags" signalling misconduct, citing to, among other things, the fact that the officer himself was engaging in such misconduct. The officer moved to dismiss the claim, arguing that Delaware law did not impose oversight duties on corporate officers. However, the Delaware court declined to dismiss the claim, instead clarifying that officers do owe Caremark duties of oversight comparable to those of directors that require them to (i) make a good faith effort to establish an information system to identify red flags and significant corporate issues, and (ii) address and report upward any red flags they discover. The court did recognise that this duty, as applied to officers, is context-driven and will differ depending on the role of the officer. For example, for officers that have particular areas of responsibility, such as a CFO or Human Resources Officer, their oversight duty will generally be limited to establishing information systems and addressing red flags within their departments whereas other officers, such as CEOs, have a company-wide oversight duty.

Shareholders seeking to bring Caremark claims against officers will still face significant challenges, including the need to demonstrate demand futility, which generally requires a showing that a majority of the board was conflicted with respect to the lawsuit and demonstrating bad faith on the part of the applicable officer, which is one of the highest pleading standards in Delaware practice. Nevertheless, this decision could encourage shareholders to seek corporate books and records about officers or even make litigation demands on boards concerning officer oversight claims.

Prior to the McDonald's litigation, in August 2022, the Delaware General Assembly amended Section 102(b)(7) of the Delaware General Corporation Law to permit companies to adopt charter provisions exculpating certain senior officers (in addition to current exculpation provisions, in favour of directors) for monetary damages arising out of breaches of their fiduciary duties of care. Previously, Delaware companies could adopt exculpation provisions only for the benefit of directors. In order to adopt an officer exculpation provision, a Delaware company needs to amend its charter, which requires shareholder approval. There are also certain limits to the scope of such provisions, including that they cannot be used to exculpate duty of loyalty breaches or intentional misconduct (among other limitations), which means that they do not apply to claims involving Caremark breaches. Still, the McDonald's decision signalled the willingness of the Delaware courts to expand officer liability, which could have contributed to the decision by hundreds of companies to include an officer exculpation proposal in their proxy statement this proxy season.

For example, as of 5 May 2023, approximately 200 companies have filed proxy statements seeking shareholder approval of an officer exculpation proposal. While only a fraction of the proposals have been voted at this point in the proxy season, a significant majority of the officer exculpation proposals that have gone to a vote have passed (after receiving average support of 92% of the votes cast). In fact, only five officer exculpation proposals have failed so far, and in each case the determinative factor for such failure appears to be low voter turnout (eg, high numbers of broker non-votes) that prevents the proposal from receiving approval from the requiring percentage of shares outstanding, rather than shareholder disapproval of officer exculpation, as all of these proposals received approval from over 90% of votes cast. ISS has also generally supported the adoption of officer exculpation proposals; only recommending against such proposals at non-Delaware companies or Delaware companies with dual class stock. In light of the high levels of support such proposals have received to date as well as general concerns over the potentially increasing risk of officer liability, we are likely to see an increase in the number of companies seeking to adopt officer exculpation provisions next year.

Director Qualifications

Recent regulatory developments, high-profile corporate failures and challenging macro-economic conditions have heightened the focus on director qualifications, with investors and other stakeholders increasingly looking for assurances that boards have adequate skill sets to ensure effective oversight. Shareholders have submitted a number of proposals over the last few years requesting increased disclosure of director qualifications and/or the appointment of directors with specific skills, such as environmental, cybersecurity or human resources experience. Recent proxy contests have also focused more on individual director qualifications following the SEC's adoption of the universal proxy rules, which mandate the use of a "universal" proxy card listing both the company's and the dissident shareholder's nominees in contested board elections held after 31 August 2022. Under these new rules, shareholders are now able to "pick and choose" a mix of nominees from both slates (whereas, previously, shareholders voting by proxy had to choose between voting on the company's proxy card or the dissident shareholder's), thereby making it easier for activists and shareholders to target and replace specific directors whom they view as underqualified or underperforming.

Taking advantage of these new rules, the first few universal proxy campaigns have become more individual-focused, with the activists focusing more on comparing the perceived weakest company nominees with their own nominees in order to garner support, rather than the differentiation of their overall platform.

In response to this growing scrutiny, boards have begun to prioritise the appointment of directors with experience in more functional areas that are viewed as increasingly important to stakeholders, such as technology and human resources. A June 2022 Spencer Stuart survey of 107 S&P 500 and MidCap 400 nominating/governance committee chairs found that adding new skills to the board was the most important factor driving board refreshment, while another Spencer Stuart survey conducted in May 2022 of 590 directors found that 21% were seeking to appoint new directors with ESG expertise. Future regulatory changes could also add pressure to boards to seek out directors with particular practical experience. For example, both of the SEC's proposed climate-related and cybersecurity rules would require companies to disclosure whether they have climate-related or cybersecurity experts on their boards, which, if adopted, could ultimately provide activists with additional information to scrutinise directors in future campaigns.

"Pass-Through" Voting

In 2022, amidst growing criticism of BlackRock's ESG practices, BlackRock became the first major institutional investor to unveil a voting choice or "pass-through" voting programme that gave certain institutional investors the option to decide how BlackRock would vote their underlying shares with respect to certain matters, like ESG, and BlackRock has since announced that it is expanding this programme to include retail investors in select mutual funds this year. State Street and Vanguard soon followed suit, announcing that they would launch their own voter choice programmes beginning this year.

Although each programme differs slightly, eligible investors under these programmes are generally given certain options to choose from regarding how their shares will be voted, including (i) deferring to the fund's stewardship team to make the voting decisions; (ii) having their shares voted in accordance with certain third-party, off-the-shelf policies (such as ISS and/or Glass Lewis policies); or (iii) following the applicable company's board recommendation with respect to each proposal to be voted on.

By dispersing the voting power held by these large institutional investors, these programmes could have significant consequences in future proxy seasons. For example, because each programme allows investors to choose to vote pursuant to proxy advisory firm policy, if this option is selected by a large number of investors, it could significantly increase the voting influence of major proxy advisory firms like ISS and Glass Lewis. These programmes could also amplify the voting influence of certain select shareholders, like activists pushing short-term interests, particularly as they expand to retail investors.

Advance Notice By-law Litigation

Advance notice by-laws have taken on renewed importance following the SEC's adoption of the universal proxy rules, which generally make it less costly and time-consuming to launch a proxy contest. Following recent SEC guidance confirming that the notice and disclosure obligations imposed on shareholders under the universal proxy rules apply in addition to any requirements imposed under a company's advance notice by-law, over 500 public companies decided to review and update their advance notice by-laws to ensure that they will provide the company with sufficient time and information to evaluate any dissident shareholders or proposed nominee during a proxy contest. Expanded requirements have focused both on the categories of information that must be disclosed, as well as extending the types of persons about whom disclosure must be made.

In general, recent Delaware cases confirm that Delaware companies have broad discretion to impose disclosure obligations under their advance notice by-laws. These cases have repeatedly emphasised that robust advance notice by-laws will be upheld so long as they are reasonable, unambiguous, applied equitably and adopted on a "clear day" when no threat was present. However, some companies have instituted aggressive requirements that have tested the boundaries of what constitutes a reasonable advance notice by-law.

In one notable situation in October 2022, Masimo Corporation was sued after it amended its advance notice by-law in response to an activist campaign to impose a number of informational requirements viewed by the activist and many other stakeholders as being "draconian", including requirements for a shareholder seeking to make a nomination to disclose (i) the identity, and certain investment holdings of, their financial backers, like limited partners, even though such information is often subject to confidentiality requirements and (ii) the shareholder's future plans to nominate individuals and/or submit proposals at other companies, which could reveal the shareholder's investment plans or strategies. The activist alleged in its lawsuit that these changes were egregious and would effectively preclude certain shareholders from nominating directors due to their hesitation to disclose such pieces of information. Ultimately, Masimo amended its by-laws to remove the enhanced disclosure requirements before the court came to a decision on the validity of the by-laws. However, companies seeking to enhance advance notice by-laws may look to Masimo as an illustrative example of a by-law that could be viewed as going too far.

Workers' Rights and Freedom of Association

Employee retention issues and other employee-related challenges spurred by the aftermath of the COVID-19 pandemic have translated into an enduring shareholder focus on company human capital practices and workers' rights. While workers' rights issues cover a broad range of topics ranging from minimum wage, to paid sick leave policies, to workforce safety, freedom of association and collective bargaining rights have recently taken the main stage. Just last year, Amazon workers at a Staten Island warehouse made headlines when they voted to join a union, despite the company's aggressive campaign against unionisation efforts.

Demands to protect workers' freedom of association have translated into an increase in shareholder proposals. For example, in early February, the New York State Comptroller and NYC Retirement Systems submitted several proposals at major companies (including Walmart, CVS and Netflix) that have faced numerous labour controversies regarding workers' freedom of association and collective bargaining rights. In particular, these proposals request the target company to (i) adopt and publicly disclose a policy on their commitment to respecting workers' rights (for those companies that do not currently have such a policy) or (ii) conduct a third-party audit of the company's adherence to its stated commitment to such risks (for those companies that have already adopted policies). A similar proposal passed (after receiving 52% support) at Starbucks earlier this year while another was withdrawn at Apple after Apple agreed to conduct the third-party assessment of its labour practices.

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