2023 ANNUAL LETTER TO BOARDS

LEADING THE WAY: NAVIGATING VOLATILE MARKETS AND MACROECONOMIC FORCES

Against a backdrop of challenging macroeconomic forces, our 2023 annual letter to boards is one that emphasizes understanding and preparing for the additional hurdles that will compound and be compounded by these macroeconomic forces.

Freshfields

How to Be Prepared for M&A Strategies in 2023

Regulators during 2023 will continue to use antitrust and foreign investment regimes to try to impede M&A strategies. Boards have to be prepared to resort to litigation, innovative fix-it-first strategies, and well-designed "efforts" covenants and "outside date" provisions to assure that the merger parties are aligned and prepared to survive the gauntlet of regulatory hurdles. In addition, understanding the interplay among the global regulators – especially the UK CMA, EC, China's SAMR, and the US antitrust agencies, as well as CFIUS and the European, Asian and UK national security regulators – will be critical for boards to effectively evaluate risks and successfully execute their M&A projects.

We anticipate that it will be advisable for boards looking to divest businesses to continue to consider distributions of the business via a spin-off (including a Reverse Morris Trust), which allows for greater certainty of execution and an opportunity for a cash yield from leverage. A split-off, where the parent company offers shareholders the opportunity to exchange parent shares for SpinCo shares, achieves a similar outcome with the additional benefit of retiring parent shares and thereby enhancing EPS.

Many boards will have to become familiar in the coming months with the direct lending market, which is going to be the critical component for leveraged M&A in the near-term. Boards and management teams will need to understand how the process of obtaining commitments from direct lenders differs from, and in many ways is more burdensome than, the traditional approach of obtaining commitments from banks.

Finally, with the macroeconomic factors potentially accentuating differences in valuation views between parties, the temptation to resort to bespoke earn-out and contingent value arrangements to bridge these valuation differences will increase. Boards will need to carefully consider the value leakage and costs of such arrangements, including the potential for adverse impacts on governance, ability to obtain synergies and taxes.

Fiduciary Duties in a Distressed Market

A spectrum of factors is now causing companies to experience liquidity constraints. As a practical matter, when a company is facing stress or distress, the director's role becomes more burdensome. More frequent meetings become advisable and the pressure on directors to stay on top of fast changing developments relating to the balance sheet and capital structure increases. Most importantly, management and outside advisors must step up under these circumstances to provide the board with comprehensive oral and written updates and analyses of the different alternatives and the impacts and execution risks of these alternatives, while always portraying these updates and analyses against the backdrop of the company's latest internal liquidity and performance forecasts.

In addition, it is important for directors of troubled companies to manage potential conflicts of interest with care. Mismanagement of personal conflicts lies at the heart of breaches by directors of their duty of loyalty. One of the most frequent missteps under the duty of loyalty occurs when a director withholds material information from the other directors because of a misunderstanding that a duty of confidentiality to a third-party excuses directors from their duty of candor to their fellow directors. Indeed, navigating the requirements of the duty of loyalty is particularly difficult for directors that, as a result of other relationships, owe duties concurrently to an investor in, or commercial partner of, the company (this is particularly the case for sponsor designees sitting on portfolio company boards). Significantly, exculpation and indemnification are not available to insulate directors from breaches of the duty of loyalty. The risk of personal liability for duty of loyalty breaches is especially heightened in a distressed environment.

Furthermore, directors of companies facing liquidity challenges and material downturns in performance will need to understand how their duties shift as they consider their cash burn and the possibility of insolvency and to what extent the interests of creditors need to be taken into account in driving their decision-making.

Risk Oversight

In addition to the challenging market environment, recent shifts in Delaware law have been contributing complexity to board decisions. First, Delaware courts will continue to scrutinize how directors discharge their oversight responsibilities. Recent Delaware rulings have signaled that, for "mission critical" areas of corporate operations, directors are expected to create tailored control systems so that they can readily be in a position to be notified of, and react to, red flags in these areas. We are recommending that boards consider, as appropriate, creating specialized board committees to monitor discrete risks or ensuring that review of such risks expressly lies within the purview of existing committees, requiring dedicated management level teams to report periodically to the board on these risks, and engaging outside experts to conduct risk audits to ensure that the mission critical areas are being properly identified and addressed.

Second, and relatedly, Delaware courts are now closely scrutinizing board minutes. Cursory recording of the business transacted at board meetings, or simply attaching decks to sparse minutes, will be given little weight in a board's defense of claims that it failed to fulfill its duty of oversight, particularly in connection with any motion to dismiss a complaint. To receive credit for their work in fulfilling their duty of care, we are recommending that boards and committees adopt a more nuanced approach to minute-keeping, adding sufficient detail to show monitoring, consideration of, and reaction to, risks. We also recommend that minutes reflect factors and analyses considered in reaching decisions and list requests for management follow-up. The minutes of subsequent meetings should reflect the extent to which management follow-up has occurred and whether the board is satisfied with management's response or requests more follow-up. It is further important to record in the minutes (through addendums and introductory paragraphs) director interactions that occur between formal meetings, particularly if these discussions bear on significant board issues.

Third, Delaware courts continue to be more willing to give shareholders broad access to corporate "books and records" in response to Section 220 demands. The definition of the term "books and records" has now been expanded to include not just minutes, but also management materials and in certain instances emails and even text messages. Moreover, shareholders can in certain instances obtain privileged materials by showing they cannot obtain the information they seek from a non-privileged source. We recommend ensuring that comprehensive board-level records exist to obviate the need to delve into the directors' and management's emails, texts and internal materials. In addition, we recommend additional management and board level trainings on best record-keeping practices and the use and preservation of privilege.

On the federal enforcement side, the SEC has advanced its enforcement agenda through the active use of national investigative task forces that focus on specific industries and market sectors. We recommend that audit committees review company preparedness for responding to regulatory inquiries and have a roadmap for responding constructively to potential subpoenas or requests for voluntary cooperation.

Activism

The increase in dispersion in performance among peer companies, as well as uncertainties about long-term internal forecasts, provide fertile ground for activists. We anticipate that, in 2023, we will continue to see an increase in campaigns by both first-time and long-time activists, coupled with a limited ability of structural defenses to prevent activism from succeeding. Indeed, the SEC-mandated universal proxy for all proxy contests will further eviscerate the effectiveness of structural defenses against activism. We continue to recommend that boards quickly adopt enhancements to advance notice, adjournment and other provisions in bylaws and governance guidelines that can come in handy if and when the board finds itself defending the company against an activist campaign or living with a new director who has a relationship with an activist shareholder.

In addition, we anticipate seeing activists in 2023 leverage both the pro- and anti-ESG movements, as well as the concerns of non-shareholder constituencies, for their benefit as they see fit. And while some of the tactics may be evolving, at the end of the day, the objectives of activists in 2023 will remain the same as over the last decade – capital reallocation, portfolio rationalization, increase of margins, and sale of the company – as will the means – threatening and implementing changes to the composition of the board and management and publication of white papers and poison pen letters.

The best way for boards to prepare is to focus on unifying the board and management behind, and communicating effectively to shareholders and other constituencies, the company's strategic agenda and judgments on potentially controversial issues.

Governance

The anti-ESG movement will become more prevalent in shareholder proposals at a time when the SEC's position on the exclusion of shareholder proposals from a company's proxy statement has become more proponent favorable, leading to a significant rise in the number of proposals put to a vote of the shareholders. As companies consider their messaging relating to their ESG efforts, they will need to be mindful of conflicting views on these issues, not only among their shareholders but among other stakeholders as well, as they try to navigate potentially damaging reputational consequences on what are often sensitive or divisive issues. We have been advising companies and boards to thoughtfully review their ESG priorities within the context of their business model, focus on those that are strategically important to the company, and craft messaging and engagement strategies that tie these key ESG strategies to the company's bottom line.

As proxy season approaches, directors will need to be mindful of the voting guidelines of institutional investors and proxy advisory firms that seek to hold directors accountable individually for perceived failings by the companies on whose boards they sit. For example, the proxy advisory firms will recommend voting against one or more directors if the board does not comprise a sufficient number of diverse directors, if the company is not making sufficient progress on climate initiatives or if the company has adopted any of a number of provisions that are deemed adverse to shareholder rights. Many shareholders either follow the proxy advisory firm recommendations or have adopted similar policies of their own. Coupled with the movement toward allowing more pass-through voting by some of the larger institutional investors (such as BlackRock), these developments may lead to lower percentages of support from shareholders for many directors.

In addition, even though the SEC has delayed finalizing the so-called "climate rule" as it considers the thousands of comment letters and the specter of a constitutional challenge, those companies for which Scope 3 emissions (the key hot button issue in the proposed rule) are an issue will continue to be under pressure from shareholders and other stakeholders to provide relevant disclosure.

Compensation

Executive compensation will be in the spotlight in 2023. The SEC recently adopted two new rules that will put executive pay front and center during the upcoming proxy season and beyond.

The SEC's final pay versus performance rules require most US-listed companies to include in their proxy statements beginning in 2023, tables showing the relationships between executive pay and certain financial metrics (TSR, net income, and another company-selected financial metric) and related narrative and graphical disclosures. These new rules require unorthodox calculations of executive pay and have the potential to confuse investors and enhance investor scrutiny of executive pay programs.

Separately, the SEC's final compensation clawback rules will require all US-listed companies to adopt by early 2024 a clawback policy that provides for recovery of excess incentive compensation erroneously awarded to executive officers during the three years before the company is required to file a financial restatement.

This is all happening at a time when investors are more focused than ever on executive pay – the 2022 proxy season saw the greatest number of votes against say-on-pay (approximately 3.5 percent of Russell 3000 companies failed their say-on-pay vote this year) and an increasing number of shareholders have shown a willingness to hold certain directors (particularly those sitting on the compensation committee) responsible for perceived poor pay practices (compensation concerns were identified as a primary reason in approximately 10 percent of the failed director elections in Russell 3000 companies this year).

In addition, a number of evolving stakeholder concerns and macroeconomic trends will cause boards to have to think carefully about how to compensate management. First, boards will need to balance increasing pressure from certain investors to include ESG metrics as a component of their incentive compensation plans with pressure from those constituents who support the anti-ESG movement. Boards should carefully consider whether incorporating ESG metrics into incentive plans is appropriate for their companies and, if so, which metrics should be used to adequately incentivize management for ESG considerations that are tied to company performance. Second, the volatility in the global economy over the past year may result in boards being confronted with decisions similar to those they faced at the end of 2020 around existing performance awards where performance is below minimum levels and the challenge of setting performance metrics and terms for go-forward performance awards.

Against this backdrop, we are encouraging boards to carefully review the pay practices at their companies to assess the relationship between executive pay and company performance.

Cyber/Privacy

Privacy and cybersecurity obligations continue to develop at a rapid pace while the significance of the consequences of a failure to comply with these obligations increases. For example, 2022 has shown that executives may face criminal exposure for concealing data breaches from US regulatory authorities. In light of heightened enforcement activity from regulators and increased willingness to hold individuals accountable, companies need to: (i) carefully review their incident response plans and governance procedures; (ii) ensure that all employees, including management, are aware of their obligations in the event of a breach; and (iii) ensure that the company has a defensible protocol for assessing and reporting potential incidents within its leadership hierarchy.

In addition, the SEC has now proposed rules that will seek to require publicly-traded companies to provide greater transparency about their cybersecurity practices, including public reporting of material cybersecurity incidents within four business days following a determination that the incident is material. These requirements underscore the need to implement the previously mentioned protocol designed to bring this information to management's attention within the required timeframe to permit disclosure decisions. They will also need to consider the impact that this additional disclosure will have on the company's reputation and stock price.

Compounding any new rules out of the SEC are proposed reporting obligations for critical infrastructure pursuant to forthcoming Cybersecurity and Infrastructure Security Agency regulations and civil exposure for government contractors under the newly implemented DOJ Civil Cyber Fraud Initiative. Additionally, new state data privacy laws, including major expansions to California's Consumer Privacy Act (CCPA), will impose significant new obligations and restrictions on the collection, use, and sharing of personal information.

In light of these expanding cybersecurity and data privacy developments, boards need to have their management teams report to them about their plans for and results of actively reviewing data governance controls, including mandatory internal reporting protocols for cybersecurity incidents, and assuring that their data privacy compliance programs are sufficient to comply with the new and updated requirements taking effect in 2023.

Thriving in this environment will require careful preparation, a focused approach and decisive leadership, while being nimble enough to adapt to the inevitable challenges that the current market dynamics will bring. The broad and deep interdisciplinary team at Freshfields stands ready to guide your board and management through these challenges and opportunities.

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