Skadden

The Informed Board

Spring 2024

Artificial intelligence is not just about chatbots. Increasingly, it is used by government for enforcement, and boards need to prepare for that, just as they need to get ready for upcoming climate disclosure requirements.

Those are two of the topics in this issue of *The Informed Board*. We also provide guidance on the critical role boards play in ensuring spin-offs are successful, and we explain how courts are closely scrutinizing the disclosures companies make when they seek shareholder approval of transactions. Finally, in our latest podcast, Skadden's Ann Beth Stebbins discusses with investor relations adviser Rebecca Corbin when and how directors should engage with investors.

AI-Enabled Compliance: Keeping Pace With the Feds

- The U.S. government is rapidly expanding its use of AI and other data analytics tools to detect wrongdoing.
- To keep up, companies need to adopt similar technology as part of their compliance programs.
- Data tools are now available from a variety of vendors to help flag high-risk business activities and continuously monitor information for possible violations, and these can earn the company credit in the event of an enforcement action.
- AI technology can also be used after a government investigation is launched to quickly assess a company's potential exposure.

The potential for artificial intelligence (AI) to transform business has commanded enormous attention over the past year. Little noted, however, is the U.S. government's increasing — and increasingly sophisticated — use of AI to spot wrongdoing. Various arms of government are now employing AI tools to flag everything from earnings manipulation to bid-rigging and imports made with forced labor.

With the tools now at the government's disposal, the capacity to manage and analyze data has become a cornerstone of effective corporate compliance programs, both so that companies are not blindsided by enforcement agencies that have identified problems the companies could have spotted first, and to demonstrate that they have robust systems to detect potential violations, which can be a mitigating factor if the government seeks penalties.

Where AI Is Being Used by the Government

Some branches of the federal government have already been using data analysis tools for years. But a broad October 2023 executive order from the White House outlined a government-wide AI policy with detailed directives to various departments, and some of those involving enforcement are now being acted upon.

Here are some of the existing and upcoming applications of AI in enforcement that are likely to have the greatest impact on businesses:

The Securities and Exchange Commission (SEC): For over a decade, the SEC has harnessed AI and other data analytics to detect trends in the thousands of tips, complaints and referrals it receives and to uncover potential insider trading.

"Just as we are upping our game when it comes to data analytics, we expect companies to do the same."

— Assistant Attorney General Nicole Argentieri

In addition, in 2018 it launched the Earnings Per Share (EPS) initiative, which uses risk-based data analytics to uncover potential accounting and disclosure violations stemming from earnings management and other improper practices. That has resulted in at least six enforcement actions, most of which have involved fraud charges and significant penalties.

Department of Justice (DOJ): Three years ago the Procurement Collusion Strike Force in the DOJ's Antitrust Division established a program to develop data tools to identify suspicious bidding patterns, and the Criminal Division recently touted the use of data to identify potential wrongdoing involving foreign corruption.

Department of Homeland Security (DHS): The DHS plans to hire 50 AI experts in 2024 and will use the technology to, among other things, police supply chains to curb the import of goods made with forced labor and to prevent imports of fentanyl and precursor chemicals. AI technology will also be used to combat AI-related theft of intellectual property.

Department of Health and Human Services: AI tools are being used to detect counterfeit pharmaceuticals and medical devices, as well as Medicare and Medicaid fraud, waste and abuse.

Environmental Protection Agency: An experimental AI model has been tested to improve the detection rate of hazardous waste violations during site inspections.

Two Reasons To Consider Adopting AI for Compliance

The first reason to employ AI technology is that it can greatly enhance a company's ability to ensure compliance and identify possible violations.

The second reason is that the government expects it. The DOJ is "going to double down on these efforts … to identify additional misconduct that may otherwise have gone undetected," Assistant Attorney General Nicole Argentieri said recently. "Just as we are upping our game when it comes to data analytics, we expect companies to do the same."

The importance of adopting these tools has only been heightened by the emphasis the DOJ has placed since 2022 on the role of voluntary self-disclosure of possible corporate misconduct. The new technology can help businesses to uncover possible wrongdoing before the government does, allowing self-disclosure, and demonstrating a company's commitment to rigorous compliance — factors the DOJ has repeatedly stated will earn the company credit if the DOJ seeks to impose penalties.

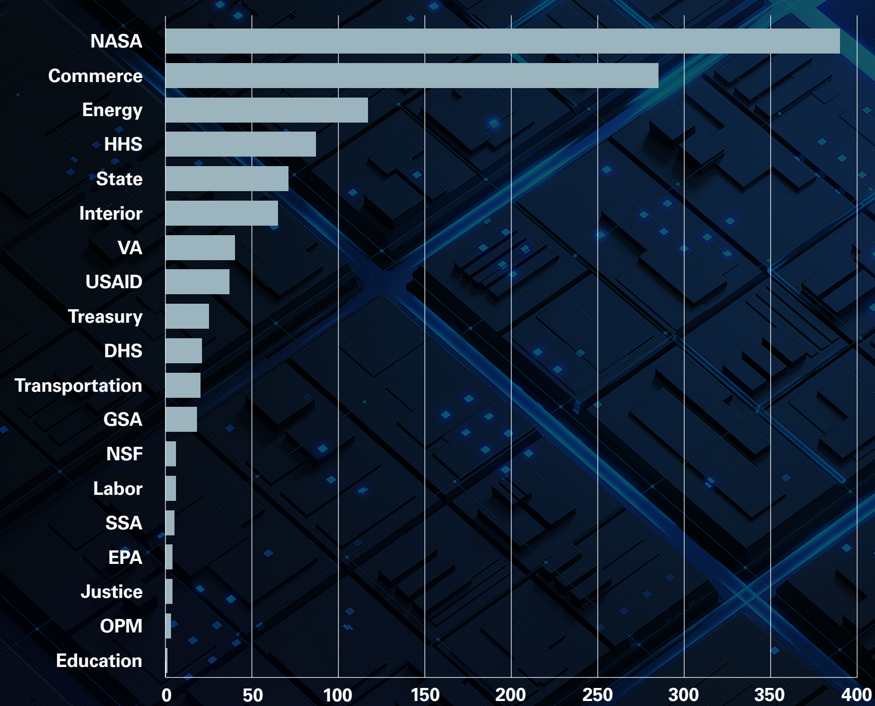
For instance, in the DOJ's Criminal Division, prosecutors are instructed to assess in detail whether compliance programs are "based upon continuous access to operational data and information across functions." And officials have cited a recent settlement involving the Foreign Corrupt Practices Act where the DOJ viewed positively the company's use of data analytics for monitoring and measuring the effectiveness of its compliance program.

Federal Government Explores Hundreds of Potential Uses for AI

Federal government departments reported more than 1,200 potential uses for artificial intelligence within their remits in response to a survey by the General Accounting Office released in December 2023, and they said that AI was already being used for 228 purposes. Many of the possible applications — by the National Aeronautics and Space Administration (NASA) and Department of Commerce, for instance — involve scientific research. But other departments cited potential uses for enforcement purposes.

The responses were as of September 30, 2023, a month before the White House issued its 20,000-word Executive Order with specific mandates to departments on AI uses.

Potential AI Use Cases Reported by Federal Departments



Source: Government Accounting Office, December 2023

Note: Figures were reported for the fiscal year ended September 30, 2023, before the Executive Order setting out a govenmnent-wide AI policy was issued. Figures apparently do not include independent commissions and agencies.

What Companies Can Do: The Rise of Suptech

Fortunately, supervisory technology (suptech) — machine-learning technology that lessens the burden of complying with or supervising compliance with regulatory requirements — is revolutionizing compliance. There are many vendors developing these products, which can be implemented using a company's existing data sources.

Strategies that companies might consider adopting include:

- **Predictive compliance analytics.** These tools can continuously assess and update the risk profiles of various corporate activities — from foreign dealings to procurement processes — and help identify patterns like those the DOJ's Procurement Collusion Strike Force might look for, enabling companies to address potential issues proactively. This can be paired with a real-time, AI-driven compliance dashboard for continuous monitoring, so that companies can swiftly identify and rectify potential breaches.
- **AI-enhanced whistleblower systems.** Advanced platforms to receive whistleblower complaints that prioritize and anonymize reports not only encourage a culture of integrity but also enable early detection and self-reporting of issues to regulators.

- **AI-assisted management of regulatory changes.** AI systems dedicated to tracking and analyzing regulatory changes can help ensure that companies remain ahead of compliance requirements.

In the event of a government investigation, the adoption of these will serve as evidence of a diligent, data-informed approach to compliance, potentially mitigating penalties.

Using AI To Navigate Investigations

In the event of a government investigation, AI tools can help a company determine early on its degree of exposure. Such tools can process vast amounts of data at speeds and depths impossible for human investigators to perform — sifting through years of transactional data, for instance, to identify anomalies that may indicate irregular payments such as bribes or unauthorized disbursements. By learning from historical data, these systems can flag transactions that deviate from established patterns within hours, not weeks.

AI tools can also analyze enormous repositories of emails, documents and text messages to predict their relevance to an ongoing investigation.

This targeted approach allows companies to get preliminary answers to threshold questions about an investigation.

Limitations

There are some caveats. Integrating new technologies with existing systems presents significant challenges, including compatibility issues and the need for training and change management. Companies must also ensure that the technologies they deploy comply with data privacy protections and other laws.

In addition, the underlying code may become stale, or a typo in the code could set an unwanted parameter or limit. As a result, human oversight and ownership are still critical. One can expect regulators to scrutinize the algorithm or model of any compliance program in case of an investigation.

Governance Priority: a Proactive Stance on Compliance

As sophisticated AI-enabled regulatory scrutiny intensifies, compliance technology has transitioned from being a supplementary tool to being a central pillar of corporate governance.

By employing advanced tools, companies can enhance their ability to stay within the law, and position themselves to address problems proactively in the event of a possible violation and improve their regulatory outcomes.

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Mind Your Disclosures: Delaware Courts Are Asking Just When a Stockholder Vote Is 'Fully Informed'

- Delaware courts are scrutinizing disclosures made to obtain stockholder approvals, particularly where there is an alleged conflict of interest in the decision-making.
- If disclosures for a vote are incomplete or misleading, directors may not enjoy the benefit of the business judgment rule if their decisions are later challenged in court.
- Some alleged conflicts have involved directors' relationships with the counterparty or management, or financial or legal advisors' work for the counterparty.
- Courts have allowed suits to go forward where a controlling person allegedly steered the board to a particular bidder in ways that were not disclosed.

A fully informed stockholder vote can help protect a company and its directors from lawsuits challenging a transaction. Under Delaware law, board decisions may enjoy deference under the business judgment rule where stockholder approval is obtained after they have received all material information. And, if the business judgment rule applies, it is easier to get a stockholder suit dismissed at the pleadings stage, before burdensome discovery.

But that hinges crucially on the stockholders being *fully informed*. And when a transaction or other board action approved by stockholders is challenged, Delaware courts have been closely scrutinizing the disclosures the company made. The state's courts have invalidated a number of stockholder approvals in recent years and allowed stockholder suits — typically naming directors — to go forward where disclosures were found to be incomplete or misleading.

Here is what boards need to know about the situations where companies and their boards were deprived of the "cleansing effect" of a stockholder vote and were left open to litigation.

A Quick Legal Primer

The Delaware Supreme Court has held that, in general, where a non-controller transaction is "approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies."

Where a "controller" — a majority stockholder or someone who in other ways controls decision-making at the company — is involved, the business judgment rule will not apply to transactions with the controller unless the parties agree (before economic negotiations begin) to condition the deal on approval of both an independent, disinterested and empowered special committee *and* a majority of the minority stockholders. Otherwise, it will be subject to court review under the more onerous "entire fairness" standard and the company and its board will have the burden of proving "that the challenged act or transaction was entirely fair to the corporation and its stockholders."

These doctrines were spelled out in state Supreme Court decisions in 2014 and 2015, but have been applied and clarified in a number of more recent rulings. Crucially for boards, courts have stressed that the vote must be *fully* informed, and they look closely at the materiality of disclosures (and omissions) and ask whether missing information would significantly alter the total mix for a reasonable investor.

Advisor Conflicts

Disclosures about conflicts of interest or relationships between the board of directors and its financial and legal advisors have tripped up some companies.

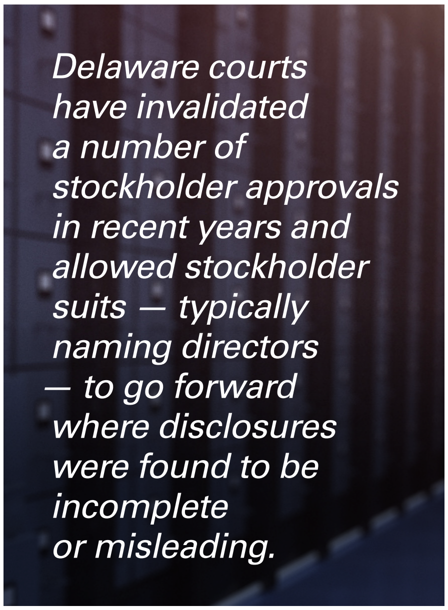
This year, for example, the Delaware Supreme Court reversed the Court of Chancery (the trial court) in a case challenging a squeeze-out merger. The lower court had dismissed the challenge, finding that the special committee and the vote by disinterested stockholders were sufficient to offset the underlying conflict of interest in the controller transaction.

On appeal, the Supreme Court held that the stockholder vote was not fully informed because the proxy statement failed to disclose:

- That the special committee's financial advisor had a $470 million stake in the controller and its affiliates.
- That the special committee's legal advisor had prior and ongoing representations of the controller.
- The benefits the controller would obtain from the transaction.

The court found that those conflicts were material to the stockholder vote. As a result, the case was remanded to the trial court to examine the transaction under the onerous entire fairness standard.

In another case this year involving advisors' conflicts, the Supreme Court reversed the lower court's dismissal, citing the fact that the proxy statement did not disclose that both financial advisors to the company had prior business relationships with other parties to the transaction. While the proxy disclosed that one of the advisors "may provide" services to counterparties in the transaction, the court found this misleading because the company knew that the advisor was actually providing these services.



"Boards, committees, and their advisors should take care in accurately describing the events and the various roles played by board and committee members and their retained advisors," the court wrote.

Board Interactions With, and Preferences for, Particular Bidders

Delaware courts have taken a similar approach to disclosures involving interactions with bidders, and efforts by directors or executives to steer a deal to one bidder.

A 2022 decision held that a filing in response to a tender offer was misleading and incomplete with respect to meetings between two directors, the acquirer and its financial advisors, and refused to dismiss the case. The court found a pattern of inaccuracies designed to obscure the fact that the entire board was not aware of these meetings, and to cover up insider trading activity. It found two other material omissions, as well: The conflicted directors had purchased shares in the acquiring company and the proxy did not contain reliable financial projections.

Similarly, in 2018, the Delaware Supreme Court reversed the dismissal of a stockholder's suit where the plaintiff alleged these material omissions about conflicts of a director-founder of the target:

- That the director-founder had expressed a clear preference for and commitment to the eventual acquirer and reluctance to entertain other potential bids.
- The reasons why the director-founder wanted to sell the company and why he believed the board should pursue a sale.

Because of these omissions, the court found that the stockholders' decision to tender their shares was not fully informed.

In a 2023 case, the Court of Chancery found that a stockholder vote was not fully informed because the proxy did not disclose:

- That other bidders were subject to standstill provisions preventing them from acquiring more stock of the target and from requesting waivers of their standstills.
- That the acquirer repeatedly breached its standstill agreement and the target's management did not enforce it.
- Details regarding the target officers' retirement plans and the impact of those on the officers' motivations.

As a result, the court found that the officers might have breached their fiduciary duties to the stockholders during the merger negotiations and it allowed the suit to go forward.

Director and Officer Conflicts

Another area of disclosure Delaware courts continue to pay particularly close attention to is the conflicts of interests of directors and officers, including details regarding compensation, post-transaction employment and relationships with a company's controlling stockholder.

In 2020, the Court of Chancery found a stockholder vote was not fully informed because the proxy did not adequately disclose the conflicts of the CEO or provide the company's correct earnings guidance. Private interactions and discussions concerning prospective future employment for the CEO were material facts that needed to be disclosed, the court found, so the stockholder vote did not insulate the transaction from challenge under the business judgment rule. (The CEO was later found liable for breaches of fiduciary duty.)

In a case this year, the Court of Chancery allowed a stockholder challenge to the equity compensation for a CEO and controlling shareholder notwithstanding the fact that a majority of disinterested stockholders had approved the package. The court found that the compensation was subject to an entire fairness review because the stockholders were not fully informed for two reasons:

– The proxy inaccurately described key directors as independent, when several of them had extensive, long-standing personal and professional relationships with the CEO and owed much of their personal wealth to him.

– The proxy omitted details about the process by which the compensation grant was approved, including material preliminary conversations between the CEO and the compensation committee chairman.

As a result, the court invalidated the compensation package notwithstanding the stockholder approval.

Other Disclosure Issues

Disclosures involving conflicts of interest are not the only ones getting a close look. Other examples where stockholder approval did not immunize a deal from challenge in the Court of Chancery included:

– Where the proxy statement did not include all sale prices proposed by a special committee; misrepresented the expertise of the special committee's financial advisors and their compensation arrangement; and misrepresented a prior valuation of the classes of stock.

– Where "intrinsic value" was mentioned 15 times in the proxy statement but the board did not disclose the specific figure reflecting that value despite recommending the transaction. (The case was dismissed on other grounds.)

– Where stockholders of a SPAC challenged its merger with an operating company (the target), the proxy statements failed to disclose that the target's largest customer was building an in-house platform to compete with the target.

Conclusion

These cases demonstrate the care with which Delaware courts are approaching disclosures where they are alleged to be inadequate. In order for a board to get the benefit of judicial deference to its decisions under the business judgment rule, the company's disclosures about the circumstances surrounding the transaction must be complete and not misleading.

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Best Practices: How a Board Can Enhance Shareholder Value Creation in a Spin-Off

- Strong board decision-making and engagement can be crucial to maximizing shareholder value in a spin-off.
- Due to high interest rates and the current capital markets environment, companies are increasingly considering variants on the traditional spin-off structure such as "sponsored" and "retained stake" spin-offs, which present unique costs and benefits.
- Boards should be thoughtful about pre-spin discussions with third parties regarding strategic transactions because the rules surrounding tax-free spin-offs may create limitations on future transactions.
- In determining the spun-off entity's (spinco's) corporate governance structure, the board should weigh a number of factors to best position the spinco for success.
- Boards will want to take an active role in certain key investor relations and communications matters regarding the spin-off.

In an article last year, we discussed the increased pressure companies face to separate businesses that are not deemed "core," and why tax-free spin-offs and similar transactions may be the most appealing way to achieve this.

Here we discuss the board's role in executing a successful spin-off once a decision to pursue one has been made. While day-to-day execution of a spin-off will largely be the responsibility of management, boards have an important role to play throughout the process in order to maximize shareholder value through the transaction.

Variants of the 'Plain Vanilla' Spin-Off Are Increasingly Common, but They Can Complicate the Process

The parent in a spin-off typically will need to right-size its capital structure by refinancing a portion of its existing debt. Often that is accomplished by the spinco issuing debt and using the proceeds to pay off a portion of parent's debt.

However, we have observed an increased focus on equity transactions with spincos, executed before or concurrently with the spin-off, that either facilitate parent debt refinancing, provide additional capital for the spinco, or help establish a more stable trading market in spinco stock. In particular, certain companies may find these transactions more appealing in light of the continued high-interest-rate environment.

Tax considerations play an important role here. The tax-free nature of the spin-off can generally be maintained so long as at least 80% of the shares are distributed to existing shareholders or securityholders. This means that a maximum of 20% of the spinco equity may be issued to other investors in advance of the spin-off. Under a separate rule, the aggregate

Once the spin-off process is underway, management and employees can quickly fall into Team A and Team B camps, lobbying for management positions or the allocation of assets. Managing those inevitable conflicts is a vital part of the board's function during the spin-off process.

amount of spinco entity that can be issued to non-parent shareholders and securityholders as part of a plan with the spin-off cannot exceed 49.9% by vote or value.

Where the goal is to provide additional capital for the spinco or establish a more stable market in its stock, a parent board may consider a direct equity investment in the spinco by "anchor" investors through a private placement, executed concurrently with the spin-off or in an IPO ahead of the spin-off. A parent may also use the proceeds of that transaction (distributed to parent in a pre-spin dividend) to repay its existing debt.

In other cases, we have seen parent companies retain a 20% or smaller stake in the spinco following an 80% or greater spin-off, which the parent then uses to further adjust its capital structure. That can be accomplished by exchanging spinco equity for parent debt, exchanging spinco equity for parent equity or selling spinco equity for cash.

Particular transactions may pose additional tax issues which will need to be carefully assessed. In addition, boards will have to weigh potential drawbacks to these structures:

- The added time needed to negotiate a private placement with a third-party.
- The restrictions on the spinco management resulting from having a significant third-party investor.
- Potential execution risks entailed by a significant private placement or an equity-for-debt exchange (*e.g.*, regulatory approvals).
- The potential impact of any "overhang" on the trading price for spinco stock.

Potential Pitfall: Discussions With Third Parties About Strategic Transactions

The decision to pursue a spin-off often comes as part of a larger review of strategic alternatives. In addition, the announcement of a spin-off may prompt unsolicited inbound proposals for transactions involving the spinco or the parent company. In addition, the parent board may expect that, as an independent entity, the spinco — or even the parent — may be better positioned to pursue certain strategic transactions.

But companies should be cautious about any discussions or communications prior to the spin-off with third parties over strategic transactions with either the spinco or the parent because those could jeopardize the ability to consummate those transactions while maintaining the tax-free status of the spin-off.

In general, the spin-off could end up being taxable to the parent if there is an acquisition (or multiple acquisitions) of 50% or more of parent or spinco's stock and that acquisition is deemed part of a "plan" with the spin-off. There is a statutory presumption that an acquisition of the parent or spinco stock that occurs within two years after a spin-off is part of a "plan." However, crucially, there is a safe harbor available if there were no "substantial negotiations" regarding the acquisition with the specific acquiring party during the preceding two-year period.

Awareness of this potential pitfall should guide any third-party discussions regarding alternative and/or post-spin transactions because they could make it impractical for tax reasons for either the parent or the spinco to enter a transaction with those parties for an extended period after the spin-off.

Establishing Strong Spinco Governance and Management To Position the Spinco for Success

The parent board will want to take an active role in establishing the corporate governance framework for the spinco, and in selecting its directors and senior management. Some boards assign these tasks to an existing committee (such as the corporate governance committee), while others establish an ad hoc committee. In any case, the full board should ultimately approve the final approach and management choices.

Spinco Board Framework and Classified Boards

We often (but not always) observe boards replicating their existing corporate governance structure at spinco. The one exception is with respect to a classified (staggered) board for the spinco. Classified boards are far more common among newly spun-off companies than public companies generally.

Parent boards will want to evaluate the pros and cons of a classified board. A classified board with a reasonable sunset provision (*e.g.*, board classification maintained until the first or second annual meeting following spinoff unless shareholders vote to extend it) may benefit the spinco and its shareholders, ensuring that the new board and management can execute on the strategic vision for the company during its initial stages as a public company without being unduly distracted by external pressures.

However, institutional and other shareholders may not be supportive, because classified boards may be viewed as adverse to shareholder rights. A reasonable sunset clause will be a mitigating factor.

The parent board should also decide the spinco board's committee structure. This will in part be driven by stock exchange requirements (*e.g.*, requirements for audit and compensation committees), but directors will want to consider whether other committees, such as an executive committee or risk committee, would be prudent.

Spinco Board Composition

When choosing individual spinco directors, parent boards typically pay careful attention to the professional expertise of potential directors, as well as considering "softer" skills

Pre-spin discussions with third parties regarding alternative and/or post-spin transactions potentially could make it impractical for tax reasons for either the parent or the spinco to enter a transaction with those parties for an extended period after the spin-off.

in order to insure a collegial and productive spinco board dynamic. To achieve a breadth of perspectives, as well as to address diversity initiatives of the parent company, institutional shareholders, proxy advisory firms and stock exchanges, the parent board should also consider gender, ethnicity and other forms of diversity. Concerns about directors serving on too many boards (including the voting policies of shareholder advisory firms and institutional investors on "overboarding") should also be borne in mind.

Note that, if some directors are to serve on both the parent and spinco boards, consideration will need to be given to legal limitations on overlapping/interlocking boards. U.S. antitrust laws may prohibit sharing directors if there is more than de minimis competition between the spinco and a director's other companies, including the parent. A substantial parent-spinco board overlap could also pose issues with respect to the tax-free treatment of the spin-off.

Lastly, the parent board will want to consider the independence and expertise requirements for directors (*e.g.*, requisite audit committee expertise).

Spinco Management Selection

Directors will want to take an active role in selecting the senior management of spinco. While they may be drawn from existing management, the parent in some cases engages executive search firms to locate external candidates, just as they would for selecting new members of senior management in other circumstances.

Similarly, boards will want to work to establish compensation schemes for the spinco management and directors. These will often mirror parent's policies, but we have also seen boards make targeted adjustments to reflect the specific circumstances of a spinco.

Monitoring the Personal Dynamics That Typically Arise in a Spin-Off

The board will exercise its authority to frame the potential spin-off at the outset when it is deciding whether to pursue that strategy. Working with advisers and management, it will determine the best portfolio re-alignment — what assets will stay in the parent and what will be assigned to the spinco — taking into account the business characteristics and macroeconomic factors. Recently, we have also noticed boards paying particular attention to how certain mixes of businesses (on the parent or spinco side) could face greater refinancing challenges in the current high interest rate environment.

But many detailed choices about particular assets and the management structures of the post-spin parent and spinco will be made later. And once the spin-off process is underway, management and employees can quickly fall into Team A and Team B camps, lobbying for management positions or the allocation of assets.

If one of the two entities is perceived to have greater growth potential, for instance, employees may prefer to have roles there. And executives may favor assigning particular assets or personnel to the entity where they will end up.

Managing those inevitable conflicts is a vital part of the board's function during the spin-off process, and the board should make sure that, where disagreements arise, there is an escalation path that gets to a "neutral" arbiter (whether that be the board or someone in management) who is looking at the issue from the point of view of what is best for *current* shareholders as whole.

Working With Management on How the Spinco Is Marketed

While the initial decisions about the make-up of the spinco's business will be the most crucial factor in positioning the "story" of the spinco, we have seen boards take an active role in the marketing of the spinco.

Financial Projections and Exchange Ratios

Some boards devote significant attention to the spinco's financial projections, or expectations about dividend policies or leverage targets, prior to those being announced publicly.

Boards will also typically work closely with their financial advisors to determine the number of shares of the spinco that will be distributed and the resulting exchange ratio. This will have important implications for the future stock price of the spinco and, in the case of any split-off or other exchange offer, any premium will impact the potential uptake of those shares by the existing shareholder group.

Announcement Timing

In addition to taking an active role in the selection of the spinco directors and senior management, a board should also be actively involved in managing the announcement of those decisions. At a minimum, it should be certain that each director or member of management is willing to serve before their names are announced, and likely should finalize compensation for them before any announcement.

A variety of factors may affect when that information is released. Externally, it may be beneficial to convey progress toward execution of the spin-off, creating positive market momentum. Internally, announcing appointments can reduce uncertainty about future positions and reporting lines, and the expected time frame for completion of the split, which can be helpful in retention efforts.

Lastly, we have also observed boards taking a keen interest in the public messaging around the anticipated timeline for completing a spin-off. There is obviously intense pressure to complete an announced spin-off as quickly as possible, and yet any number of factors may result in delays (*e.g.*, complex IT systems that need to be separated, expanding regulatory oversight in many countries, or financing challenges).

Ultimately, boards will want to craft with management an anticipated timeline to be made public that conveys both the vigor with which they intend to pursue the transaction and a realistic estimate of the time needed for completion. If an overly ambition target date is not met, the board and management could be seen to be guilty of poor execution or insufficient planning.

The Parent Board Retains Its Role as Key Decision-Maker Until the Spin-Off Is Complete

Boards commonly ask when and how future directors of a spinco should be integrated into the process of executing the spin-off and setting up the spinco. In our experience, the more common (and, indeed, better) approach is for the future spinco directors (other than those already on the parent's board) to be informed of the status of the spin-off process at appropriate intervals but not given a role in shaping or driving the process.

This means that the spin-off directors are neither formally appointed to any positions prior to the spin-off (as the spinco remains a wholly-owned subsidiary of the parent), nor consulted on an informal basis with respect to decision-making. Rather, the parent board remains the key decision-maker.

This is appropriate because the parent board is still the body legally responsible for overseeing parent and all its subsidiaries, including the spinco, until the spin-off is completed. Under Delaware law, the board's fiduciary duties clearly remain to the existing shareholders of the parent, not the future shareholders of the spinco.

Keeping decision-making with the parent board also avoids undue delay and any unintended consequences that could arise from a spinco-centric approach to the transaction.

To facilitate the spinco board's assumption of control of the spinco when the spin-off is consummated, parents may conduct a series of informal "onboarding" sessions to educate and update the prospective directors, without involving them in substantive decision-making.

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Preparing Now for the SEC's New Climate Rules

- Even though the Securities and Exchange Commission's (SEC's) climate-related disclosure rules are on hold while court challenges are heard, companies need to prepare for the possibility that some or all parts of the rules will come into effect.
- A growing number of states and other countries are requiring similar disclosures, which can include quantitative and qualitative measures of the climate impact of operations, projected climate-related risks and progress toward sustainability goals.
- Directors need to consider how oversight responsibility for compliance should be allocated within the board and its committees, and what metrics the company should use to provide the highly detailed disclosures the rules mandate.
- Beyond compliance with government requirements, the growing number of climate disclosure regimes is likely to shape the expectations of investors and other stakeholders.

On March 6, 2024, the SEC adopted new rules mandating climate-related disclosures in public companies' annual reports and registration statements. As anticipated, the rules are facing multiple legal challenges, which have been consolidated in the U.S. Court of Appeals for the Eighth Circuit.

In light of these legal challenges, the SEC voluntarily stayed the effectiveness of the new rules while the rules are under judicial review. Under the compliance schedule as originally adopted, large companies would be required to comply beginning with their 2025 annual reports.

While the stay buys additional time for companies to comply, and the litigation leaves the ultimate status of the rules uncertain, companies nonetheless need to lay the groundwork to comply in case some or all of the rules do come into effect. Below are key considerations for boards.

What should companies do pending the legal challenges and SEC stay?

The challenges and the stay do not necessarily mean pencils down for companies when it comes to enhancing internal controls and making other preparations for climate-related disclosures, although there may not be the same sense of urgency now. Even if the SEC's climate rules are scaled back or overturned, many companies still would be subject to other climate disclosure requirements, such as new mandates in California (which are also subject to pending legal challenges) and/or Europe. Taking all the uncertainties into account, companies will need to balance their own risk tolerance, climate disclosure readiness and competition for compliance resources.

What information will need to be disclosed?

Although the SEC's final climate rules were meaningfully scaled back from the commission's original proposal, they nevertheless add potentially extensive climate-related disclosure requirements. Required information includes:

– Baseline climate disclosures, including material climate-related risks, strategy, targets/goals and governance. The rules also require a new note to the audited financial statements regarding "severe weather events and natural conditions," whether or not related to climate change.

– Material expenditures that are a direct result of (i) climate-related risk mitigation/adaption, (ii) disclosed transition plans and/or (iii) disclosed targets/goals (or actions taken to achieve/progress toward those targets/goals) and their impact on financial estimates and assumptions.

– For larger companies, Scope 1 and/or Scope 2 greenhouse gas (GHG) emissions, if material, with third-party attestation to the disclosures' accuracy.

(Deadlines for compliance vary according to a company's filer status and the type of disclosure.)

These disclosure requirements are based in part on the disclosure frameworks of the Task Force on Climate-related Financial Disclosure (TCFD), which focuses on governance, strategy, risk management, and metrics and targets, and the global GHG Protocol.

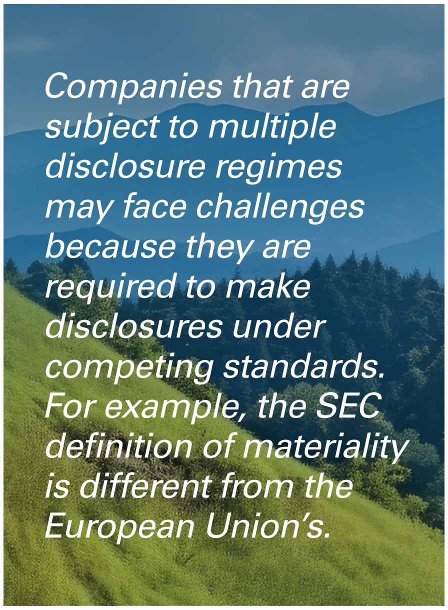
The SEC, however, declined to adopt an existing framework and instead created its own standards in response to feedback on the proposed rules. The SEC also declined to permit companies to use an existing framework as an equivalent standard for SEC purposes.

As a consequence, companies that are subject to multiple disclosure regimes may face challenges because they are required to make disclosures under competing standards. For example, the SEC rules are based on materiality under the traditional reasonable investor standard, whereas the European Union's Corporate Sustainability Reporting Directive is based on so-called "double materiality," taking into account both financial impact and external impact on the environment and society.

What should boards focus on now?

With the prospect of the SEC rules eventually taking effect on the horizon, here are issues that boards should be contemplating in their oversight role.

– **Governance structure.** Climate-related risks can take many forms, and it may not always be clear which board committee(s) should be responsible for overseeing particular types of risks. Boards should ensure that appropriate board and/or committee oversight



is in place for all relevant climate risks. For example, climate-related financial impacts may fall under the audit committee's purview, while broader sustainability strategies may be better addressed by the nominating and corporate governance committee, or the full board. For some companies, a standalone ESG or sustainability committee might be best positioned to oversee climate-related risks. In addition, given that the new SEC rules require both quantitative and qualitative climate-related disclosures in audited financial statements, audit committees should provide appropriate oversight of disclosure controls and procedures, and internal control over financial reporting with respect to climate-related matters.

– **Identifying and assessing climate-related risks.** Under the SEC rules, climate-related disclosures in many cases will be required only if they are determined to be material, and companies will be required to disclose the processes they use to identify, assess and manage any material climate-related risks. The SEC staff in recent years has indicated in the course of reviewing company filings that it may scrutinize companies' materiality determinations for climate-related disclosures. As a result, companies will be expected to have robust processes to identify and assess climate-related risks.

– **Disclosure committee composition.** As part of disclosure controls for climate-related matters, companies should consider whether their disclosure committee (or an equivalent body) has relevant subject matter expertise or, if not, whether experts are able to escalate potentially material climate-related issues for the committee's review.

– **Measuring progress.** Companies that have set climate-related targets/goals, whether publicly disclosed or not, would need to assess on an ongoing basis their progress toward those targets/goals, and that may need to be disclosed in SEC filings. Boards should help ensure that the company's process for measuring progress is appropriate and that the company remains on track to achieve the established targets/goals.

– **Compliance readiness for all jurisdictions.** In addition to the SEC rules, multiple state and foreign jurisdictions either have adopted or proposed climate-related disclosure rules that may become relevant for certain companies, depending on the nature and scope of their operations. As a result, companies may need to navigate a complex mix of climate-related regulatory requirements.

- **Stakeholder expectations.** In addition to regulatory requirements, climate-related disclosures are also driven in part by demands from investors and other stakeholders. Companies should continue to engage shareholders and other stakeholders regarding their expectations and consider whether and how those expectations should be factored into climate-related risk management processes.

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Podcast: **When and How Directors Should Engage With Investors**

Listen to the podcast

"Our research does indicate 57% of investors appreciate some form of board-level shareholder engagement. That could be controlled access. It also could mean direct access," says Rebecca Corbin.

In this episode of the *Informed Board* podcast, our host, Skadden M&A partner Ann Beth Stebbins is joined by her guest, Rebecca Corbin from Corbin Advisors, to explore the critical role that board directors play in shareholder engagement. Corbin stresses that a proactive, not merely reactive, approach toward shareholder engagement is essential for success.

In their conversation, Ann Beth and Rebecca discuss how a board can best stay attuned to investor sentiment, the practical actions a board can take to spread the culture and message of the company, and what to do when an investor requests a meeting with one or more independent directors.

Looking at topics that investors are focused on, the episode explains that ESG continues to be an important factor in investment decisions, along with corporate culture, a facet that, if expressed effectively, can offer a competitive edge. Future-readiness is another key theme, highlighting the necessity for boards to have diversified skill sets that align with the company's strategic trajectory.

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