Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

A Guidebook to Boardroom Governance Issues

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Introduction

In recent years, we have seen boards and management increasingly grapple with a recurring set of governance issues in the boardroom. This publication is intended to distill the most prevalent issues in one place and provide our clients with a useful and practical overview of the state of the law and appropriate ways to address complex governance problems. This publication is designed to be valuable both to public and private companies, and various governance issues overlap across those spaces, although certainly some of these issues will take on greater prominence depending on whether a company is public or private. There are other important adjacent topics not covered in this publication—for example, the influence of stockholder activism or the role of proxy advisory firms. Our focus here is on the most sensitive issues that arise *internally* within the boardroom, to help directors and management run the affairs of the corporation responsibly and limit their own exposure in the process.

The Purpose of the Corporation and the Role of Stakeholders

Corporate purpose, along with the related question of whether and how a board of directors should consider non-stockholder interests—such as environmental, social, and governance ("ESG") issues—has become a major source of debate among policymakers, lawyers, academics, institutional investors, and even jurists in recent years. This debate challenges the dominance of stockholder primacy ideology, which has effectively constrained corporate boards since at least the mid-1980s.

Under the stockholder primacy framework, directors have to justify all actions as benefitting stockholders. Although a board can select a time frame for those benefits to be achieved, the fiduciary duties of directors run to stockholders and the ultimate purpose of those duties is to maximize stockholder value.

Now many business leaders and investors are calling for a change or reconceptualization in corporate governance ideology. This movement would encourage, or even require, directors to consider all corporate stakeholders when making their decisions. For example, on August 19, 2019, the Business Roundtable issued a new statement arguing that the purpose of the corporation must be to "create value for all" of the company's stakeholders, not just serve stockholders. Delaware Supreme Court Chief Justice Leo Strine has also called on corporate boards to focus on "creating quality jobs in a way that is environmentally responsible, fair to consumers and sustainable," rather than simply producing returns to stockholders.

Leading institutional investors have also entered this debate, encouraging companies to consider broader stakeholder interests. BlackRock CEO Larry Fink is often credited as one of the leaders in this movement, as his letters to CEOs over the last several years have called for a "new model of corporate governance." Under this model, BlackRock urged corporate leaders and boards to focus on long-term strategy, including thinking about how corporate strategy impacts "broad structural trends" in the economy, from wage growth and income inequality to climate change and rising automation. Similarly, Vanguard and State Street, the second and third largest institutional investors as measured by assets under management, have been outspoken on ESG issues, pushing directors to consider the long-term interests of all corporate stakeholders when making decisions.

Such statements dovetail with certain other trends. In 2013, the Delaware statute was amended to permit Delaware corporations to choose to become public benefit corporations—with the board of such a corporation being required to balance stockholders' pecuniary interests, a specified public benefit purpose, and the interests of those materially affected by the corporation's conduct. We have seen some uptick in interest within our client base on this form of organization. We are also seeing more companies explore the possibility of becoming certified as a B Corporation, which requires considerable commitment to a diversity of interests and considerations.

While these pronouncements and developments are significant, the practical question for directors of a traditional Delaware corporation is what impact they will have on a board's ability to take action that the board reasonably believes is in the best interests of corporate stakeholders other than stockholders. To squarely present a hypothetical issue, can a board of a traditional Delaware corporation defend a decision not to outsource jobs and pay higher wages to reduce income inequality, while openly admitting that such policies will actually reduce stockholder value by reducing corporate profits?

Sticking to the hypothetical—and in particular not taking the easy way out by justifying the board's decision on the basis that in the long-term the stockholders will benefit because the company will get better employees—Delaware law presents some complexities on that issue. Indeed, much of corporate law since at least the mid-1980s and arguably long before then is based upon the concept that the primary duty of directors of a for-profit corporation is to promote the corporation for the benefit of its stockholders. Although the business judgment rule gives directors considerable discretion to make decisions that can be justified by benefitting the long-term interests of stockholders, the general legal consensus, at least in Delaware, remains that board actions still must ultimately further stockholder value.

Moreover, even if corporate law allowed directors to take action supportive of stakeholders that did not benefit stockholders, the practical reality is that stockholders have the exclusive power to elect directors. Stockholder influence over boards has increased in recent years as a result of the heightened concentration of voting power over public corporations in a relatively small number of institutional investors and activist hedge funds. As a result, until large institutional investors vote in support of corporate behavior that does not primarily benefit stockholders—for example by taking into account the real long-term interests of their contributors rather than just stock price—then the debate about corporate purpose and ESG issues may remain more theoretical than real.

At the same time, there is some possibility that, in the coming years, all of these forces will harmonize. The business judgment rule does, under the current case law, give boards wide latitude to take into account various considerations in promoting and advancing the value of the corporation. Consistent with that reality, directors can choose under Delaware law to pursue long-term, rather than short-term, value for stockholders, an approach that can necessarily sweep in a multitude of stakeholder considerations. In addition, we could see a greater understanding setting in that best governance practices, and the best interests of a corporation, equate with directors considering the needs of all corporate stakeholders when making decisions. On various issues, the long-term success of corporations may well depend on it.

Board Deliberations and the Handling of Corporate Information

Delaware courts have expressed certain views about how boards of directors function. There is a belief among judges that all board members can get together in a room or on a conference call and, keeping in mind their shared fiduciary duties of care and loyalty to act in the best interests of the company and its stockholders, act as a unit to share thoughts and ideas and come to a collective decision that is better than any of them could develop alone. In cementing that viewpoint, there have been many high-profile corporate disputes in which directors with diametrically opposed preconceived notions have been appointed to boards and then changed their minds after being fully apprised of their duties and deliberating as part of a board.

In order to allow this alchemy of collective insights and effort among board members, the case law has developed to encourage collective and informed discussion. As a general matter, directors are expected to be candid and forthcoming with each other. They usually must share all information of which they are aware that might be relevant to a given decision, and decisions that follow complete, thorough live meetings tend to be given more deference than decisions that are quickly dispensed with through approval by written consent. The Delaware courts disfavor particular directors being unfairly “ambushed” at a meeting, and where decisions are made simply by informally “polling” directors outside of proper board action, such decisions may not be honored. Beyond that, a corporation’s officers generally have obligations to help provide all directors with corporate information, with each director’s rights to corporate information being “essentially unfettered.” The thinking goes that directors need to be fully informed in order to develop trust and confidence in each other and to arrive at optimal decisions. The Delaware General Corporation Law (the DGCL) further provides directors with broad rights to information, essentially drafted with a presumption that directors have a right to *almost* any and all corporate information that they seek.

But this is not always the case. At times, a given director has potential or actual interests so adverse to the rest of the board—or to the collective best interests of the corporation and its stockholders—that officers and directors are permitted to find ways to keep information from such a director. For example, this dynamic could arise where an affiliated fund of a director is engaged in a proxy contest and related litigation with the company. This dynamic also commonly arises if a particular director, or an affiliate of a particular director, proposes a transaction with the company. Delaware courts have recognized three general exceptions concerning when corporations may withhold information from a director.

First, the courts have suggested that a director could be denied access to information provided to other directors if, in advance, the corporation contracted for limitations on that director’s access. A director may consider this type of arrangement if he or she is affiliated with a specific stockholder who wants to avoid being cast as a “constructive insider” limited in its ability to trade in the company’s stock or to compete with the company. However, the case law addressing these types of pre-arrangements to restrict a director’s access to information is limited, and there may be risks that a director might not be able to carry out his or her duties without full information.

Second, a director may not be entitled to certain information if sufficient adversity exists between the director and the corporation such that the director could no longer have a reasonable expectation that he or she is a client of the board’s counsel. The case law offers some examples of when such "adversity" might arise. For example, Delaware courts have held that adversity clearly existed between a director and a corporation following the launch of a proxy contest by that director's fund and when a director was affiliated with an entity that was involved in pending litigation against the corporation. Similarly, "concrete" evidence that a director will misuse information or otherwise do harm to the corporation also would constitute requisite adversity sufficient to deny a given director's rights to categories of corporate information. However, short of such concrete evidence of adversity, Delaware judges wrestling with these disputes during contentious litigation have been hesitant to label a sitting director as adverse to the corporation.

Finally, but most commonly, an exception can exist where a board forms a committee. Specifically, a board may act openly, with all directors' knowledge, pursuant to Section 141(c) of the DGCL to appoint a special committee to address certain matters in confidence. Such a committee can be treated essentially as its own body, able to hire its own legal counsel and establish and maintain its own attorney-client relationship.

In such a scenario, a director who is not on the relevant committee may feel inappropriately cut out from the business of the company: how can this person continue to serve as a capable director if some sort of "board within a board" is operating a critical component of the business in secret, he or she might ask? It is possible that, at least in some circumstances, a committee may need to provide some sort of periodic update to the whole board from time to time or upon request, but any such obligation would likely depend on the facts in a given situation.

Director Independence and Conflicts of Interest

In today's world of stockholder litigation, directors must be aware of and navigate potential conflicts of interest as they carry out their fiduciary duties. One primary reason for this is simple: independence is a foundational element of a director's entitlement to business judgment deference and can make a significant difference in the event of stockholder litigation. As a result, independence is often the first target of stockholder plaintiffs and closely scrutinized by judges in corporate governance litigation.

At the heart of corporate governance is the deference given to many types of business decisions made carefully by directors who are disinterested and independent when making the decision. That deference, known as the "business judgment rule," is the doctrinal basis for judges' general refusal to allow stockholder-plaintiffs to challenge a large swath of rational decisions by the board of directors. The result in litigation, when the court affords business judgment deference to director-defendants, is that the lawsuits can, and often will, be dismissed at an early stage before the plaintiff is able to demand information through the discovery process and before the judge considers the merits of the challenged business decision.

When, however, the presumptions underlying that deference are found to be inapplicable in litigation challenging a board decision, the court will shift the burden of proof to the directors and, depending on the circumstances surrounding the decision, the directors must then show that the transaction was either reasonable or entirely fair. These standards are known as enhanced scrutiny and entire fairness review. Judges can apply enhanced scrutiny in particular types of contexts such as a sale of control or the board's use of "defensive" measures such as a poison pill. Entire fairness review can apply where half or more of the board has a conflict of interest in a given situation and often results in protracted, costly litigation in which the question before a court is whether directors breached their duty of loyalty and should be held personally liable for damages. Under the entire fairness standard, a court closely examines whether the transaction, as to both terms and process, was fair to stockholders.

As a general matter, independence refers to a director's ability to make decisions in a fiduciary capacity that are uninhibited by concerns and allegiances other than the best interests of the corporation and its stockholders, i.e., potential conflicts. Recent Delaware cases suggest that courts may have greater willingness to probe directors' personal and professional relationships than previously expressed in cases holding that similar relationships among directors do not compromise independence.

More than 15 years ago, in litigation alleging that Martha Stewart had engaged in insider trading, the Delaware Supreme Court addressed whether Martha Stewart Living Omnimedia directors were independent of Stewart.[1] Although the directors were alleged to have "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,'" the Court determined that the directors were not "so beholden to an interested director (in this case Stewart) that his or her discretion would be sterilized."

The Martha Stewart decision stands in contrast to more recent decisions involving Tesla, Zynga, Oracle, and Sanchez Energy[2] where the courts looked to interrelationships between directors to find a lack of independence in situations where, among other things, directors owned an airplane together, served on other company boards together, vacationed together, invested in other companies together, and had longstanding personal friendships. Delaware courts have also questioned the independence of directors where they were affiliated with universities that received large donations from interested parties, where they were reliant on significant director fees for a substantial portion of their income, and where they did not meet independence requirements under stock exchange rules (although courts have also been quick to note that meeting such independence standards does not guarantee independence).[3] Beyond these circumstances, directors could be viewed as conflicted where they are affiliated with a particular stockholder (such as a venture or private equity fund) that has an interest divergent from stockholders' interests as a whole in a given board decision. Given the Delaware courts' focus on personal and professional relationships, it is vital that directors investigate these relationships at the outset to determine whether half or more of a board is likely to be found to be conflicted.

There are a variety of contexts in which the independence of directors can have significant consequences. These include:

- *Compensation arrangements*
- *Transactions affecting corporate control*
- *Change of control transactions*
- *Transactions with other companies in which corporate insiders have an interest*
- *Affiliate arrangements*
- *Situations in which special committees and special litigation committees are formed*

When embarking on such a transaction or decision, directors should consider whether a majority of the board can be considered independent as to the transaction or decision. Having a majority of independent directors involved in negotiating and approving a transaction or decision can help ensure that, at least under many circumstances, the transaction is reviewed under business judgment deference.

Given the courts' increasing focus on independence issues and conflicts, there are a number of preventive measures that directors should consider in attempting to manage potential conflicts and the risks that can result in litigation:

Board Self-Evaluations. Board self-evaluations may be structured in any number of ways and can be helpful in identifying potential conflicts that could undermine independence determinations. The board self-evaluation process may be an appropriate initial step in bolstering the independent operation of any board of directors. However, the format, content, and medium of these evaluations should be considered thoughtfully in order to engender honest and open feedback without creating opportunities for misuse or mischief.

Independent Committees. Where board members have a special interest or a disabling relationship in a particular instance, the proper formation and use of an independent committee of the board can serve a productive and vital role—including by potentially returning the standard of review to business judgment deference in some circumstances. We discuss when, whether, and how to form a committee later in this publication.

Awareness of Relationships. There is a heightened focus on context-specific issues and relationships that can undermine the independence of directors in the governance, transactions, and litigation of a corporation. Independence can act as a powerful cleansing agent, but directors and their advisors must be aware of existing relationships and remain alert to methods for addressing the potential appearance of conflicts, or else otherwise independent directors may lose the benefits of deference from courts in litigation over their decisions. Such vigilance to identification, management, and monitoring of those potential conflicts can be an important element of a director's perceived ability to act independently.

Disinterested Stockholder Votes. In recent years, the Delaware case law has rapidly developed in providing that fully informed, uncoerced disinterested stockholder approvals can protect various types of board decisions from fiduciary duty challenges. Such approval can bless decisions made by an otherwise conflicted board. Such approval can prevent an intermediate standard of review from applying to a sale of the company. And, as we discuss later, such approval can effectively extinguish fiduciary duty challenges to compensation paid to board members.

Controlling Stockholder Conflicts of Interest

A lack of board independence is not the only way in which a disabling conflict of interest can arise: controlling stockholder conflicts of interest are another hotbed area for stockholder litigation. When a corporation has one or more large stockholders that will participate in a transaction or otherwise receive a differential benefit, the board, with the help of counsel, will want to consider whether that stockholder could be considered a controlling stockholder under Delaware law. Where a controller stands on both sides of a transaction or receives a differential benefit, the same entire fairness standard of review discussed above can apply. In the ensuing stockholder litigation, plaintiffs may seek damages against the controller, the board, and oftentimes members of management. Such litigation has arisen in various circumstances, including M&A, recapitalizations, executive compensation, consulting arrangements, preferred stock redemptions, and financing rounds.

Although stockholders ordinarily do not owe fiduciary duties to the corporation or to other stockholders, the opposite rule can apply when stockholders possess control and use that control over the corporation. Under extensive Delaware case law, control exists either where a stockholder possesses a majority stake or, at less than that, possesses control over the company's decision-making as a factual matter. As with director independence, courts examine an array of factors in deciding whether a stockholder has control—including personal influence and personality, the nature of the use of contractual veto rights (including through preferred stock terms), size of equity stake, a company's prior disclosures on the issue, and whether various directors are beholden to the stockholder. Recent Delaware case law has found that stockholders potentially possessed control at equity stakes as low as 15% and 22%.[4] Delaware law also recognizes the concept of a stockholder control group where stockholders have "legally significant" ties among them.

Where a controlling stockholder conflict could exist, boards should consider certain possible steps:

The "MFW" Framework. Dozens of recent Delaware litigations have established a framework that companies can follow to address controlling stockholder conflicts and return the standard of judicial review to the business judgment rule. This framework is often referred to as "MFW" after the Delaware Supreme Court decision that embraced this standard.[5] Under this framework, parties must declare at the outset, before "substantive economic negotiations" begin, that a transaction will not be effected unless both a fully empowered independent committee of the board and minority stockholders, by a fully informed, uncoerced vote, give their approval. Recent case law has highlighted a number of foot faults that parties can commit when attempting to use this framework, and therefore the steps must be carefully followed (including as to the proper formation of a committee, which we address further below). The use of this framework can be onerous, and a board will need to weigh litigation risks against the feasibility of this approach. But it can provide powerful protection to directors, officers, and stockholders.

The Use of a Committee or Minority Vote Alone. A board could also choose to use only one of these approaches—an independent committee or a minority vote—in addressing a controlling stockholder conflict. Under the current case law, the use of only one such mechanism will not return a transaction to the business judgment rule, but it can shift the burden to the plaintiff to show why the transaction was unfair, and it can help a board demonstrate fairness. Although less common, where a large stockholder has an ongoing conflict of interest, the board might consider forming a standing committee of directors independent of that stockholder. This concept has been discussed by Delaware Supreme Court Chief Justice Leo Strine, who has advocated the concept as a tool available to boards in order to ensure that independent directors have the resources and time to respond to a conflict situation.[6] Of course, many corporations already have an audit committee composed of directors considered independent under stock exchange listing requirements that has been delegated this type of authority, and as a result the audit committee may already be serving such a purpose if the directors can also be considered independent for other purposes. That said, it is important to consider in a given situation whether an audit committee or other similar committee has the appropriate composition and authority to address the issue at hand—and receive the benefit of improved judicial deference.

Careful Engagement by Independent Directors. In any event, where a controlling stockholder conflict exists, there is great value in designing the board's process in a manner that allows independent directors to be active and engaged and carry out their fiduciary duties. Although the entire fairness standard of review is challenging and often results in costly litigation, the Delaware case law has provided that independent directors who appear to have discharged their fiduciary duties can get out of the litigation on a motion to dismiss before discovery begins.[7]

The Formation of Board Committees in Sensitive Situations

The use of a board committee can have significant ramifications on the way that transactions or decisions are negotiated, the outcome of such negotiations, and how searching a judge's review of a transaction will be. A board committee can be established so that disinterested directors have an opportunity to deliberate in private, in a forum in which conflicted directors have no right to participate, and to use advisors who can provide unvarnished guidance and input. This is not the only reason why a committee may be formed, of course. Sometimes a board will conclude that a transaction is likely to move so quickly that a smaller subset of the board should be charged with staying familiar with the deal and be able to react more quickly and responsively, regardless of whether or not other directors have conflicts with respect to the transaction.

Several decision points will inform whether, when, and how to form a board committee, and how to structure its authority, in the context of a sensitive situation. As a practical matter, it can be a challenge to determine when to take the time and expense of forming a committee. If a possible transaction is in very preliminary stages and is unlikely to occur, it may seem inappropriate or even a waste of limited corporate resources to ask a lawyer to draft a committee charter for such an unlikely event, or perhaps even to bring the directors up to speed. But litigation always occurs in hindsight, and courts may perceive value in establishing independent board committees as early in a given process as possible, in order to avoid arguments that insiders steered a transaction in its infancy or that a committee was formed too late for disinterested directors to shape the outcome of a process. Standards of review can be improved if independent, disinterested directors take the reins at the "outset" of a transaction—and in some situations (such as where a controlling stockholder has a conflict), the case law is insistent that a board form an independent committee early on to improve the judicial standard of review that will apply in the event of litigation. The decision to form an independent committee can be a challenging issue, and one highly dependent upon the particular facts and circumstances of the situation.

If a committee is formed, it needs to be formed with the right personnel to do the job. Committee members should be selected carefully. A committee must be composed of talented, savvy directors who have the time and ability to stand firm in negotiations and understand the relevant dynamics. Delaware courts typically prefer committees to have multiple directors, which can replicate the beneficial deliberative dynamics of a larger board and can avoid a spotlight being shined on a single director. In some situations, however, boards do use committees of one. Regardless of board size, conflicts should be vetted carefully, as discussed further below, to ensure that disinterested directors comprise the relevant committee. Committee service can be a difficult, time-consuming job, and directors willing to do that job can sometimes be hard to come by. Given the expected work of the committee, compensation is frequently offered for committee service. But, speaking generally, such compensation should be specified at the beginning of the process and should not be contingent on the outcome of the committee's recommendations. Courts can examine fee structures to determine whether a committee had the proper incentives.

Committees ought to be given the time, space, and tools to do their jobs appropriately. For example, controlling stockholders have been criticized for "undermining" otherwise good committee processes when they are unduly rushed or when facts are hidden from committee members. It is generally appropriate for committees to be given the authority to retain their own legal, financial, and other advisors. Regarding financial advisors in particular, various cases have taken a close look at whether financial advisor conflicts—for example, relating to prior or ongoing work for interested parties or to a particular fee structure for the advisor—have been properly disclosed and addressed. The committee can determine to continue to rely solely on outside counsel to the company (and often this may be the best path given counsel's familiarity with the company), but the committee should in many circumstances have the authority to retain its own advisors and should consider the question of who to retain with great care.

When considering how to respond to the substantive issues they are facing, committee members should not take a "cramped" view of their mandates and instead should attempt to negotiate hard to advance the best interests of the corporation and its disinterested stockholders. As part of this process, committee members should ask hard questions of all involved, including conflicted directors, officers, and stockholders. Further, officers, employees, and agents of the company should be instructed to assist and take instruction from the committee. It is often in everyone's interests if a committee involved in a conflict transaction is given a veto over the transaction so that the committee can have the sort of negotiating leverage that would exist in an arm's-length situation. In some situations, the case law requires that committees be given such veto power in order to improve the judicial standard of review. When committees are given the opportunity to represent the interests of a corporation and its disinterested stockholders in a full-throated way, courts see such a structure as strong evidence of the fairness of ultimate outcomes.

Board Minutes

The question of how much detail should be included in board (and committee) minutes has also taken on increasing importance.

Traditionally, many companies have produced board meeting minutes with high-level summaries of discussion topics, without much detail as to the precise nature of the conversation. Such minutes are often referred to as "short-form" minutes. There are good reasons for having short-form minutes for everyday corporate decision-making, most notably because it is usually time consuming and expensive to create "long-form" minutes that accurately reflect the discussion at board meetings. Privilege considerations are also a concern, for two reasons. First, including extensive discussion of legal advice in board minutes can risk a privilege waiver if distribution of minutes is not carefully monitored, and, second, in governance litigation directors sometimes choose to waive privilege over minutes or are found to have waived privilege (which will then result in revealing detailed discussion of privileged information).

However, Delaware courts have become increasingly focused on board minutes as the main source of contemporaneous evidence of board deliberations. In situations where the extent and nature of the board's deliberative process are questioned, the best way to demonstrate that the directors fulfilled their fiduciary duties of care and loyalty is usually by including a detailed discussion of the deliberations in the minutes of the meetings.

If the board minutes do not include an adequate record of deliberations on a particular issue, savvy plaintiffs' attorneys may argue that the court should infer that such deliberation and consideration by the board did not take place. Thus, not having a sufficient record of board deliberations in the minutes can make it more difficult to avoid litigation or get the case against the directors dismissed early on in litigation.

Not having detailed minutes can also make it more difficult to prove at trial that the board actually did discuss a particular issue. For instance, one of the hotbed topics for plaintiffs, particularly in litigation over a deal in which the common stockholders received little or no consideration, is whether or not the directors considered the rights of the common stockholders as distinct from preferred stockholders. Having board minutes that document that such a discussion took place can be invaluable in buttressing director testimony on the issue. As we discuss elsewhere, minutes have also played a critical role in determining whether directors and management satisfied their fiduciary obligation to exercise proper oversight over the corporation. Similarly, to the extent that potential conflicts exist, demonstrating in minutes that the directors discussed the conflicts and sought to mitigate them can also be valuable.

In sum, while short-form minutes make sense in various contexts, there are some issues as to which a longer form of minutes may be advisable. Directors should remember that they are ultimately responsible for the content of the minutes and making sure they accurately reflect the discussion. In that vein, it is advisable that directors closely review the minutes and consider whether they appropriately reflect the board's deliberations.

Stockholder Discovery of Board Records and Electronic Communications

Directors should also be familiar with the types of board-level information and director communications that stockholders (whether litigious or not) can access and how concepts such as attorney-client privilege play out if they ultimately find themselves in litigation.

Delaware's books and records statute, Section 220 of the DGCL, is a powerful tool for stockholders to demand information for purposes reasonably related to their status as a stockholder. Common "proper" purposes that have been recognized by Delaware courts include valuing one's shares and investigating potential wrongdoing by the company's officers or directors.

Often the types of books and records that are produced are limited to board minutes and materials or summary financial information. However, depending on the circumstances, Section 220 demands can sometimes more resemble discovery in litigation, including the production of email communications from officers and directors. That said, Delaware courts try to strike a balance between a stockholder's right to access information and the board's authority to manage the business and affairs of the corporation free from burdensome and distracting information requests. Accordingly, Delaware courts are careful to point out that the production of email is the exception rather than the rule. The fundamental inquiry under Delaware law is what is "necessary" and "essential" for the stated purposes. So, for example, Delaware courts are more likely to order the production of email communications as necessary to understand board processes where there are no formal board minutes.

There is increasing authority suggesting that stockholders can waive Section 220 rights. Although it is unlikely that Delaware courts will ever apply a Section 220 waiver broadly against all stockholders in publicly traded companies, this potentially remains an option in other contexts.

When it comes to the types of internal company communications that stockholders can access, it is important to consider the interplay of attorney-client privilege. The application of privilege also has important implications for how directors communicate and record their deliberations. At base, the attorney-client privilege only protects the substance of legal advice, whether reflected in a communication from a lawyer to an officer or director of the company client or in the information provided to a lawyer by officers or directors for purposes of formulating that advice. It is a common misperception that privilege shields any and all discussions conducted in presence of counsel, whether live or by copy on an email communication. Directors need to be mindful that their email communications with other directors will likely be discoverable in litigation. In litigation, email communications are parsed down to the sentence and even the phrase so that only language that is truly privileged is redacted, and even then, privilege could end up being waived.

Directors need to be particularly mindful when communicating by text message or when using similar messaging apps or other forms of social media (e.g., WhatsApp, Twitter, or the next app to come along). It is now common practice in fiduciary duty litigation for inquiring plaintiffs' firms to demand such communications from directors and officers. In our experience, it is the rare instance that text chains involving directors also include counsel and/or reflect detailed discussions of the legal advice carefully doled out to the board. Rather, text exchanges are often more basic expressions of the directors' views, attitudes, and plans and are rarely privileged.

Plaintiffs' attorneys are particularly effective at using the timing and often abbreviated nature of texts to undermine more formal board records. A good example of this is using text messages sent around the time of, or even during, board meetings to undermine what is formally reflected in the board minutes. Directors should assume that any text with a fellow director or an officer will feature prominently in a complaint and will be read out aloud in court someday. The point is not that text messaging should be avoided or prohibited as a matter of good board governance: effective and efficient forms of communication are vital to generating firm value. Rather, directors should be mindful as they use these forms of communication of how their words can be interpreted and should never assume they will be protected as privileged.

The same goes for directors' notes taken during board meetings or jotted in the margins of board materials. They are almost always discoverable and very rarely subject to privilege redactions.

Finally, as it relates to formal board minutes, the application of privilege ends up being a key consideration, although for a slightly different reason. Careful lawyers reviewing board minutes for privilege have to balance the need to redact truly privileged information or risk waiving privilege over the subject matter of the advice and wanting to create a record of a robust board process. Accordingly, effective minutes are not drafted with the intent that large portions will be redacted from view. Rather, capable and experienced counsel will ensure that minutes feature prominently what the *directors* discussed, including with counsel, as opposed to what the *lawyers* told them.

Oversight Obligations of Directors and Officers

As part of their fiduciary duties of care and loyalty and under well-established Delaware case law, directors and officers have a fiduciary obligation to exercise proper oversight over a corporation and its compliance with the law. In practice, this means that directors and officers must establish an adequate system of controls and respond to any red flags that suggest potential failures within that system. After a corporation experiences some crisis or trauma, stockholder litigation frequently arises, asserting that directors and officers breached their oversight obligations and should be held liable for resulting damages.

Historically, fiduciary duty oversight claims have been extremely difficult for plaintiffs, as multiple Delaware judges have observed over time. In a long line of decisions referred to as the *Caremark* case law (after a leading 1996 Delaware case involving the company Caremark), Delaware judges have provided that in order for oversight claims to be successful and for fiduciaries to face any risk of liability, they must "utterly fail" to establish a system or controls or "knowingly" or "consciously" fail to respond to red flags.

Despite the defendant-favorable standard that generally applies under Delaware law, a recent Delaware Supreme Court decision provides some insight into when directors and senior management may be at risk of failing to satisfy their oversight obligations. On June 18, 2019, the Court reversed a Court of Chancery decision dismissing claims against the board and certain members of senior management of Blue Bell Creameries following the 2015 listeria outbreak at that company—which resulted in three deaths, a recall of all of the company's products, the termination of over one-third of the company's workforce, and the company's need to accept a "dilutive" private equity investment. In allowing the claims to go forward, the Court emphasized several factors. In the years leading up to the outbreak, federal and state regulators had identified various potential contamination risks and failures at the company. The company's facilities had undergone several positive tests for listeria. Food safety was *the* central compliance issue for the company, and the plaintiff alleged that nothing in the board's minutes (which the plaintiff had obtained in a stockholder books and records demand) reflected discussion of the potential problems or board-level protocols for monitoring food safety. The board did not appear to have a committee "charged with monitoring food safety." The board did not appear to dedicate a portion of time at regular board meetings to reviewing food safety issues. Further, there was no evidence at the pleadings stage that the board had adopted protocols to ensure that food safety issues were reported up to the board.

Although the recent decision serves as a cautionary tale, it also illustrates what boards can do to ensure proper oversight of a company and mitigate litigation risk. A fundamental board obligation is to identify, with the appropriate help from management (and as necessary its advisors), the company's core compliance issues—for example, cybersecurity or data privacy breaches or a particular regulatory issue or set of risks. This is an ongoing duty as the company's risks change and develop. The board should also ensure that it dedicates appropriate time to review those issues and potential concerns, at regular meetings and with the assistance of board committees as appropriate.

The board also needs to document these processes appropriately. As we discussed earlier, it is critical that boards have appropriately detailed and thorough minutes that reflect the board's activities, efforts, and follow-through. In reaching its conclusions in the recent decision, the Delaware Supreme Court relied on the premise that the board minutes did *not* contain certain information, which the Court inferred meant that the board had not taken certain acts in accordance with its oversight obligations.

Competition and Corporate Opportunity Issues

In practice, questions over corporate opportunities and competition arise quite frequently—for instance, where a corporation has one or more large investors that have board seats and may engage in competitive business activities, or where directors or other fiduciaries have involvement in other businesses that may be viewed as competitive with the corporation. Traditionally, the Delaware courts have held that directors and officers of a corporation, as fiduciaries, owe an unwavering or "unremitting" fidelity to the corporation and its stockholders—even if they have outside business interests or fiduciary obligations to other entities at the same time.

An outgrowth of this principle is that, with some exceptions, directors and officers cannot harm the corporation or divert "corporate opportunities" to themselves or to other entities. The same limitation can apply to controlling stockholders, which can be viewed as owing fiduciary duties to the corporation and stockholders in some circumstances. As we discuss elsewhere, where investors have large stakes and significant influence within a company, even at less than a majority stake, they should be mindful of the risk of being considered a controlling stockholder. Where a director, officer, or controlling stockholder breaches the duty of loyalty—which is the duty implicated by competitive and corporate opportunity concerns—the risk of lengthy litigation (and possibly even personal liability for damages) arises.

Delaware's corporate opportunity doctrine—which addresses when fiduciaries can pursue competitive opportunities—has historically been opaque, growing out of old case law, and is fact-intensive. The case law provides that a business or investment opportunity is a corporate opportunity belonging to a corporation where: (1) the corporation is financially able to exploit the opportunity, (2) the opportunity is within the corporation's line of business, (3) the corporation has an interest or expectancy in the opportunity, and (4) by taking the opportunity, the director, officer, or controlling stockholder would be placed in a position "inimical" to his or her duties to the corporation. As a corollary, the case law also provides that an opportunity is not a corporate opportunity where: (a) the opportunity is presented to such a fiduciary in his, her, or its personal capacity rather than a corporate capacity, (b) the opportunity is not essential to the corporation, (c) the corporation holds no interest or expectancy in the opportunity, and (d) the fiduciary has not wrongfully employed the resources of the corporation in pursuing the opportunity. In short, if an officer is considering an outside business venture, or if a director or large stockholder with influence is considering a competitive investment or opportunity, the corporate opportunity doctrine may be implicated.

Although the fact-intensive nature of the corporate opportunity analysis can counsel in favor of caution, there are several practical measures that investors and directors can take. In 2000, the DGCL was amended to allow a Delaware corporation, in its certificate of incorporation or by board action in a particular instance, to "renounce" the corporation's interest in an opportunity, such that a director, officer, or controlling stockholder can then take the opportunity without exposure.[8] Thus, as one avenue, a director or investor can bring a given opportunity to the board and ask for the board's permission to pursue the opportunity. As with any board decision, fiduciary duties would apply to the board's decision whether to renounce the opportunity, and parties and their advisors should be mindful of conflicts of interest that may exist when the board makes that decision. But, for example, if only one director has an interest in a competitive opportunity and has made appropriate disclosures to the rest of the board, a decision by the board to renounce the opportunity may resolve the situation.

Alternatively, a corporation can include an advance renunciation of certain opportunities in its certificate of incorporation—as commonly occurs in venture capital and private equity investments. The drafting of those provisions can matter, and questions have occasionally been raised over precisely when such provisions are enforceable.[9] But these provisions can be powerful. In a recent case involving a corporation's allegations that an investor with board seats had made competitive investments and wrongly shared information, the Delaware Court of Chancery dismissed trade secrets claims against the investor and suggested that related fiduciary duty claims against the investor would also be unsuccessful. The basis for that decision was that the investor and the corporation had included a corporate opportunity provision in the corporation's charter and had entered into related agreements providing that the investor could make competitive investments.[10]

Beyond the above considerations, when large stockholders have multiple investments in the same space, they can consider certain other prophylactic measures. This can include securing carefully established rights to corporate information up front, in order to spare their board designees (who will have fiduciary obligations to the corporation) from having to share sensitive information. Large investors can also consider the use of ethical walls and careful handling of information to minimize the risk that the investor will be accused of mishandling corporate information or placing the same board designee in multiple competing investments.

Director Compensation and Stockholder Approval

In recent years, we have witnessed an uptick in stockholder demand letters and litigation challenging director compensation. This trend has in part been fueled by significant developments in the Delaware case law.

Historically, a number of companies have sought and obtained stockholder approval of equity compensation plans that include specific upper limits on the amount of compensation that may be paid under the plan to nonemployee directors. For example, a plan might state that no nonemployee director may receive more than $500,000 in grants under the plan during a single year. The limit in some plans applies to compensation paid under the plan and also outside of the plan, effectively sweeping cash retainers into the limit.

These stockholder-approved director compensation limits often were adopted to help companies and boards defend against challenges by stockholders that nonemployee director compensation was excessive or unreasonable. The Delaware Court of Chancery held, including in *Seinfeld v. Slager*,[11] that stockholder approval of "meaningful limits" on director compensation—which limits typically were much lower than the Internal Revenue Code section 162(m)-driven limits that applied to executives—could constitute stockholder ratification that would support a deferential business judgment standard of review of a company's director compensation so long as the board exercised discretion within the stockholder-approved limits. Following that case law, a significant number of companies amended their equity plans and obtained stockholder approval in an attempt to impose such "meaningful limits."

In a 2017 decision, *In re Investors Bancorp, Inc. Stockholder Litigation*,[12] the Delaware Supreme Court severely undercut the benefits of the meaningful limits approach. The Court first reasoned that equity awards granted to directors were inherently self-interested decisions that should be reviewed under the "entire fairness" standard rather than the business judgment standard. Importantly, the Court also concluded that in order to ensure the protection of the business judgment standard of review, a board would need to obtain stockholder approval of board compensation in specific amounts—or pursuant to self-effectuating formulas—that avoided future director discretion in setting the compensation. Almost two years later, the Delaware Court of Chancery reiterated these principles in a separate decision refusing to dismiss a stockholder claim challenging the compensation of the Goldman Sachs board of directors.[13] Significantly, the Court observed that stockholders must plead facts to show that the compensation was in some way unfair. But the Court also concluded that the plaintiff had done so in that case, where each outside director received approximately $600,000 per year—an amount that was substantially above the compensation paid to outside directors in the company's peer group, even though the company was below its peer group in net income and revenue. Finally, it is worth noting that in *Investors Bancorp*, the Court allowed a stockholder to pursue a challenge to the executive compensation of management members of the board where the board's deliberations and approvals about that compensation were intertwined with the board's decisions about outside director compensation.

Given the case law and the risk of an entire fairness challenge, companies should employ a robust process when setting director compensation. Director compensation decisions ideally should be made following a careful and deliberative review of market and peer group practices, with input from counsel and an independent compensation consultant. Any proxy statement disclosure regarding the nonemployee director compensation program preferably will describe the process and reasoning for setting the director compensation amounts. These types of actions alone will not avoid entire fairness review in litigation but may make the company less likely to be a target for plaintiffs' lawyers and, in any event, should increase the chances that the company will prevail in any such review. Similarly, the amount and terms of director compensation may impact the likelihood of receiving or defeating a challenge.

Companies that want to ensure they avoid an entire fairness review altogether should consider having stockholders approve a compensation plan that specifically sets forth the cash and equity compensation that nonemployee directors will receive. To date, a relatively small percentage of companies have sought public company stockholder approval of specific director compensation amounts or formulas. Depending on future litigation trends, more companies may take this approach.

Succession Planning

Securing the long-term leadership and management of the company is one of the key responsibilities of the board. Although succession planning for the CEO is often the focus of the board, investors have increased their attention on succession planning for the directors themselves, as well as on consideration of leadership development more generally as part of human capital management and the sustainability of the enterprise. Succession planning is not a one-size-fits-all process, but companies and boards should regularly address leadership succession for both senior management roles and the board.

Executive Succession Planning

Generally, the board (or a board committee) is solely responsible for hiring the CEO, evaluating the performance of the CEO, compensating the CEO, and, if necessary, firing the CEO. A company often does not have the luxury of a long goodbye where the current CEO announces his or her plans to retire, so boards must plan for both emergency succession where there is little or no time for planning, and for the long-term leadership of the company upon an executive departure or retirement to ensure an appropriate transition of leadership to a successor.

The best time to consider succession planning is before it becomes necessary. Regular conversations about succession planning enable the board to engage with the sitting CEO without raising apprehension that his or her job is in jeopardy, and also to have a plan at the ready should the CEO unexpectedly depart or otherwise be unable to serve. Succession planning is also closely linked to leadership development, and the CEO's input and guidance in the development of his or her direct reports is critical to developing a pipeline of talent. However, succession planning need not, and should not, be limited to the CEO. Particularly at a public company, other roles, such as a chief financial officer, may be equally as critical to the company's ability to operate and meet critical timelines. Succession planning of the key executive roles will also further develop the pipeline and help ensure that the company has stable, sustainable leadership.

Although there are checklists aplenty, succession planning is inherently molded to each company. Even within a single company, the process may change depending on where the company is in its life cycle and the sitting CEO. Consider, for example, succession planning for a founder CEO or a CEO that is otherwise closely associated with the brand of the company, a CEO that holds significant voting power, or the CEO of a company that has recently undertaken a shift in strategic direction. There are some key questions that should be considered as part of the process. For example:

- Who bears primary responsibility for oversight of succession planning? Is it the full board or a committee of the board that reports up to the board? If a committee is responsible, what other inputs are needed (for example, audit committee input in CFO succession planning)?
- What are the key attributes and qualities of the office, including at this particular company?
- Emergency succession versus long-term succession: If the current executive is unexpectedly unable to serve, does the role need to be filled immediately or can others fill the gap temporarily? Is the emergency successor a potential long-term successor? Are there others in the pipeline that may, with time and guidance, develop into potential successors, and what is the timeline for development? Are potential successors willing and interested to serve?
- Internal versus external candidates: Is there a long-term successor internally? Would an external candidate be preferable? If so, who are potential realistic and reach-for-the-stars candidates?

Board Succession Planning

Historically, there has been less focus on board succession than CEO or executive succession. However, in the last several years, investors and proxy advisors have placed greater emphasis on "board refreshment" in an effort to balance stability with fresh perspectives and independence, and to avoid complacency and stagnation. It is also believed that board refreshment increases diversity on the board, which leads to better performance. Policies such as mandatory retirement ages or term limits may push the refreshment conversation forward and avoid tougher conversations, but such policies may have unintended consequences or be overly rigid. Regular conversations about succession planning for directors, and developing broader goals, such as adding one new director every three years, can be a more flexible approach and better serve the needs of the company. In addition, broader succession planning conversations enable the board to be proactive rather than reactive, consider the company's needs strategically, and ease the transition if a director departs unexpectedly. Board succession planning generally goes hand-in-hand with the board self-evaluation process and should be a natural outgrowth of that process. Some key issues to consider when discussing director succession include:

- Who bears primary responsibility for driving the conversations around board succession? Generally, the nominating and governance committee will play a key role, but the board as a whole will need to be in agreement on policies and process.

- Individual existing director evaluations:
  - Tenure: Although a balance of tenure is desirable and stability of leadership is essential, long tenures (greater than nine years) are associated with decreased independence from management.
  - Performance: Do other directors and senior management of the company believe that the director adds value in the boardroom, provides unique perspective or expertise, and has the time and interest to serve the needs of the company?
  - Outside commitments: Proxy advisors and several large investors have increased scrutiny of the number of boards on which a director serves. ISS has set the bar at five for non-CEO directors, but investors such as BlackRock and Vanguard have decreased that number to four due to the time commitment for directors, particularly if the company is in crisis.
  - Director time horizon: What is the personal time horizon for a particular director? For example, following an IPO and depending on the circumstances, a director who was appointed by an investor when the company was private may want to move on within a relatively short period following the IPO.
  - Investor input: What feedback have investors provided directly as part of shareholder engagement efforts or more indirectly through director elections?
- Board composition and diversity: Beginning on December 31, 2019, public companies headquartered in California will be required to have a specified number of female directors—although the California law providing for this requirement was recently challenged. Illinois recently adopted a law requiring certain disclosure on these issues. Other states are considering similar laws, and investors have increased the push for a truly diverse board as to gender, ethnicity, race, and background. Additionally, proxy advisors and investors have enacted more stringent policies regarding voting against nominating committee members on boards that do not meet certain diversity thresholds. Simply adding more directors may not be optimal.
- Committee membership and key roles: Are there sufficient directors who would be qualified and willing to be appointed if a member of the audit committee or compensation committee could no longer serve? Is there a successor to the board chair and audit committee chair?
- Expertise: Given the company's stage and business development, are there areas of expertise (for example, cybersecurity, international, government relations) that are needed or that would need to be replaced if a particular director could no longer serve?

Disclosure of executive and board succession planning is not required by law or exchange requirements (NYSE only requires that corporate governance guidelines address CEO succession planning policies and director qualifications). However, the ability to articulate the board's succession planning processes is becoming increasingly important. Management, stockholders, and others, including proxy advisors, look to the board to ensure the sustainability of leadership and active oversight of the company. Considering these processes prior to a crisis is an important function of the board.

Endnotes

[1] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040 (Del. 2004).

[2] *Delaware Cnty. Emps. Ret. Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015); *In re Tesla Motors, Inc. S'holder Litig.*, Consol. C.A. No. 12711-VCS (Del. Ch. Mar. 28, 2018); *In re Oracle Corp. Derivative Litig.*, C.A. No. 2017-0337-SG (Del. Ch. Mar. 19, 2018); *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016).

[3] *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003); *In re Oracle Corp. Derivative Litig.*, C.A. No. 2017-0337-SG (Del. Ch. Mar. 19, 2018).

[4] *FrontFour Capital Grp. LLC v. Taube,* C.A. No. 2019-0100-KSJM (Del. Ch. Mar. 11, 2019); *In re Tesla Motors, Inc. S'holder Litig.,* Consol. C.A. No. 12711-VCS (Del. Ch. Mar. 28, 2018).

[5] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

[6] Leo E. Strine, Jr., *Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-Making and Reduce the Litigation Target Zone*, 70 Bus. Law 679 (2015).

[7] *In re Cornerstone Therapeutics Inc., S'holder Litig.*, 115 A.3d 1173 (Del. 2015).

[8] 8 *Del. C.* § 122(17).

[9] *Alarm.com Holdings, Inc. v. ABS Capital Partners Inc.*, C.A. No. 2017-0583-JTL (Del. Ch. June 15, 2018); *Wayne Cnty. Emps' Ret. Sys. v. Corti*, C.A. No. 3534-CC (Del. Ch. July 24, 2009).

[10] *Alarm.com Holdings*.

[11] *Seinfeld v. Slager*, C.A. No. 6462-VCG (Del. Ch. June 29, 2012).

[12] 177 A.3d 1208 (Del. 2017).

[13] *Stein v. Blankfein*, C.A. No. 2017-0354-SG (Del. Ch. May 31, 2019).

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