
GOVERNANCE ROUND-UP

Delaware Supreme Court Decision Highlights Importance of Director Risk Oversight

On June 18, 2019, the Delaware Supreme Court in *Marchand v. Barnhill* reversed a Court of Chancery decision dismissing a stockholder derivative suit asserting, among other claims, breach of the *Caremark* duty by directors of ice cream manufacturer Blue Bell Creameries due to their alleged failure to provide adequate risk oversight. The suit was brought after Blue Bell suffered a listeria outbreak that led to three deaths. In its aftermath, the company recalled all of its products, shut down all of its plants, laid off over a third of its employees and, in the ensuing liquidity crisis, accepted a dilutive private equity investment.

Under *Caremark*, a director may be held liable for a breach of the duty of loyalty if the director fails to make a good faith effort to implement compliance and reporting systems for the oversight of a company's operations. In reversing the lower court decision, the Delaware Supreme Court emphasized that it would not review the effectiveness of compliance and reporting systems; instead, *Caremark* requires that directors make a good faith effort to implement them. Still, the Court noted that food safety "has to be one of the most central issues at the company" given that its only product was ice cream. Plaintiffs alleged that no board committee addressed food safety; there were no protocols to keep the board apprised of compliance issues; there was no regularly scheduled board review of food safety issues; and, despite numerous "red, or at least yellow flags" received by management, there was no evidence that the board discussed them. According to the Court, "[a]lthough *Caremark* is a tough standard for plaintiffs to meet, the plaintiff has met it here."

This case serves as a reminder that inherent in directors' duty of care is the good-faith effort to implement board-level processes and procedures designed to facilitate the oversight of enterprise risk, particularly those areas of key risk to the company.

Moody's Establishes New Governance Assessment Scoring Tool

On July 25, 2019, Moody's Investors Service published a report describing its new governance assessment ("GA") scoring tool designed to help compare corporate governance characteristics of non-financial publicly traded companies that are rated by Moody's, and to provide meaningful differentiation across issuers with regard to the potential impact of

corporate governance on credit quality. While the information underlying GAs may provide insights useful for credit analysis, GAs are not credit ratings and will not directly affect credit ratings.

The new scoring framework assesses governance in terms of five key components that Moody's believes are relevant to credit, each with various subcomponents:

- *ownership and control*, including voting rights and ownership structure, and related party transactions and conflicts of interest;
- *management compensation structure*, including compensation disclosure and compensation design;
- *board of director oversight and effectiveness*, including director leadership and independence, and director qualifications, experience and refreshment;
- *financial oversight and capital allocation*, including share buybacks and distributions (dividend policy); asset sales, divestitures or other transactions; and mergers and acquisitions; and
- *compliance, controls and reporting*, including transparency, timeliness and accuracy of financial reporting; audit quality; and compliance controls.

Within each subcomponent, there is a series of questions that require “yes/no” responses.

Each of the five components is weighted at 20 percent of the total GA score. GAs are expressed using a four-point scale between GA-1 and GA-4. Companies assigned GA-1 have overall governance practices that generally score at the highest level based on Moody's framework. Data used to determine GA scores are drawn from public disclosures such as SEC and stock exchange filings, board and committee charters, corporate bylaws, and investor presentations. Where disclosure is lacking, the company will receive a less favorable GA score.

A copy of the report, which includes a detailed breakdown of the components and subcomponents, including the series of questions under each subcomponent, is available on Moody's [website](#).

ISS Takes an Early Look at 2019 U.S. Proxy Season Vote Results

On June 5, 2019, ISS published a summary of findings from an early review of vote results for over 1,800 Russell 3000 annual shareholder meetings convened from January to May (representing approximately 70 percent of Russell 3000 meetings expected during the 2019 calendar year).

ISS identified the following trends:

- *Director elections*: Director elections face the strongest opposition seen in the past nine years, as evidenced by the increase in the number of director elections with support levels below 80 percent of votes cast. However, opposition rates remain lower than pre-2011, prior to the advent of say-on-pay proposals, when many investors expressed compensation concerns through opposition to director election proposals. ISS attributes the recent trend to increased investor scrutiny and greater complexity in investor voting policies. For example, leading institutional investors such as Vanguard and BlackRock have implemented new or stricter policies on director overboarding.
- *Say-on-pay proposals*: Opposition to say-on-pay proposals (which let shareholders vote on executive compensation programs) continues to increase to almost historical records, coinciding with record high levels of executive compensation. ISS attributes this increase to investors applying more rigor in their analysis of executive compensation programs and how they align with the company's strategy and long-term sustainable returns.
- *ESG shareholder proposals*: Shareholder proposals related to environmental and social (E&S) issues outnumber governance proposals for the third consecutive year. The median shareholder support rate for E&S proposals reached a record high of 30 percent of votes cast in 2019, compared to 39 percent for governance proposals, which is the lowest difference between the two categories on record. Further, withdrawal rates for E&S proposals remain at record high levels, which ISS attributes to changing investor expectations on key E&S issues such as diversity and climate change, public pressure on high-profile issues such as the opioid crisis and gun safety, and companies' proactive approach to engaging with proponents on E&S risks to resolve their demands.

Division of Corporation Finance Issues Joint Statement on LIBOR Transition Risks

On July 12, 2019, the SEC's Division of Corporation Finance issued a joint statement (the "Joint Statement") with the Division of Investment Management, Division of Trading and Markets and Office of the Chief Accountant reiterating that companies should prepare for, and adequately disclose risks associated with, the expected discontinuation of LIBOR in 2021.

The Joint Statement called attention to working groups formed in each of the United States, the United Kingdom, the European Union, Japan and Switzerland for the purpose of recommending an alternative rate to LIBOR for each of their respective currencies, and encouraged market participants to begin managing their transition away from LIBOR. In order to manage the transition, the SEC staff suggested that market participants identify existing contracts that extend past 2021 to determine LIBOR exposure, and also to consider whether new contracts entered into should reference an alternative rate to LIBOR. The staff

also cautioned that the risks associated with the discontinuation of LIBOR extend beyond existing and new contracts and recommended that market participants also identify, evaluate and mitigate other consequences that the discontinuation of LIBOR may have on their businesses, such as on strategy, products, processes and information systems.

The Division of Corporation Finance separately noted in the Joint Statement that a number of existing rules or regulations may require disclosure related to the expected discontinuation of LIBOR, including in risk factors, management's discussion and analysis, board risk oversight and the financial statements. The Division of Corporation Finance encouraged companies to consider the following guidance:

- The evaluation and mitigation of risks related to the expected discontinuation of LIBOR may span several reporting periods. Consider disclosing the status of company efforts to date, and the significant matters yet to be addressed.
- When a company has identified a material exposure to LIBOR but does not yet know or cannot yet reasonably estimate the expected impact, consider disclosing that fact.
- Disclosures that allow investors to see this issue through the eyes of management are likely to be the most useful for investors. This may entail sharing information used by management and the board in assessing and monitoring how transitioning from LIBOR to an alternative reference rate may affect the company. This could include qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts referencing LIBOR and extending past 2021.

ISS Identifies 2019 Trends in U.S. Board Composition

ISS recently profiled the boards of 2,175 Russell 3000 companies (including 401 S&P 500 companies) that had their 2019 annual meeting of shareholders as of May 30, 2019. ISS identified the following trends in U.S. board composition:

- *Board refreshment:* Board renewal rates continue to increase, as board refreshment, director qualifications, and board diversity remain high-priority issues for companies and investors. Over 35 percent of Russell 3000 companies introduced at least one new board member in 2019 and over 10 percent introduced at least two new members.
- *Gender diversity:* The percentage of women joining boards has reached a new record high, with 45 percent of new Russell 3000 board seats filled by women in 2019 (compared to 34 percent in 2018 and 12 percent in 2008) and 19 percent of all Russell 3000 seats held by women. Unlike previous years, when the percentage of new women directors was higher at large-capitalization companies, the rate of new women directors was consistent across all market segments.

- *Ethnic diversity:* A record high number of ethnic minorities are joining boards, although the rate of change is considerably slower than the trend in board gender diversity. Over 20 percent of new directors at S&P 500 companies were filled by ethnic minorities, and the number of Russell 3000 directors belonging to an ethnic minority group (based on board members whose ethnicity was identified) crossed the ten-percent threshold for the first time in 2019.
- *Age diversity:* The average director age continues to increase. The percentage of new directorships filled by directors younger than 45 years dropped to an all-time low of 7.2 percent in 2019, compared to 11.5 percent in 2008. The overall percentage of directors above the age of 67 continues to increase, reaching a record high of 31.6 percent in 2019.
- *Director skills:* A lower percentage of new directors exhibit traditional skills such as financial and audit expertise and CEO experience, while a greater percentage exhibit non-financial skills such as international, technical and human resources expertise.

Michigan and Pennsylvania Are Latest States to Promote Gender Diversity on Boards

On February 14, 2019, the Michigan legislature introduced a bill that would require publicly held corporations to include women on their boards of directors. The bill is substantially similar to a California law passed in September 2018 and a New Jersey bill introduced in November 2018, both discussed in previous issues of the Governance Round-Up.

The Michigan bill requires publicly held corporations with principal executive offices in Michigan to have at least one woman on the board by January 1, 2021. Beginning January 1, 2023, depending on the size of the board, certain companies would be required to have a minimum of two or three women on the board. Companies that fail to comply would be fined up to \$100,000 for the first violation and up to \$300,000 for each subsequent violation.

Pennsylvania has also taken action to promote gender diversity on corporate boards. On March 6, 2019, the Pennsylvania legislature passed a resolution resolving to encourage “equitable and diverse gender representation” on corporate boards. The resolution urges that every publicly held corporation in Pennsylvania have a minimum of one, two or three women on their boards by 2021, depending on the size of the board. While the resolution does not specify what companies would be subject to the law as “publicly held corporation[s] in” Pennsylvania, given that the resolution cites the California law, a reasonable presumption would be that the Pennsylvania law would apply similar criteria (*i.e.*, a corporation with principal executive offices in the state).

ISS Identifies Increase in U.S. Director Compensation for 2019

ISS recently published a report on trends in U.S. director compensation based on preliminary data from 2019 shareholder meetings.

ISS reported an increase in total director compensation across all market segments and continued differentiation by industry group. Median annual director compensation for Russell 3000 companies increased by 2.7 percent to approximately \$198,000, as compared to approximately \$193,000 in 2018. This figure is 63 percent higher at S&P 500 companies, where median annual director compensation was approximately \$285,000. Among S&P 500 companies, pharmaceutical, biotechnology and life sciences firms offered the highest director pay packages with median annual compensation of approximately \$347,000. A significant portion of director compensation is paid in equity across all size segments of the U.S. market, with Russell 3000 companies paying approximately 60 percent of total director compensation in equity.

ISS attributes the increased director compensation to an increasing commitment by directors to their oversight roles, along with increasing investor expectations and, in some industries, regulatory demands. Director pay levels generally correlate with CEO pay, since both figures are typically determined by the size and complexity of the company.

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