Corporate Governance and Directors' Duties in the United States: Overview

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Country Q&A | Law stated as at 01-Sep-2021 | United States

A Q&A guide to corporate governance law in the United States.

The Q&A gives a high level overview of board composition, the comply or explain approach, management rules and authority, directors' duties and liabilities, transactions with directors and conflicts, company meetings, internal controls, accounts and audit, institutional investors and reform proposals.

Corporate Governance Trends

1. What are the main recent corporate governance trends and reform proposals in your jurisdiction?

The main recent corporate governance trends and reform proposals are summarised below:

- Environmental, social and governance (ESG). Companies are increasingly disclosing ESG-related information, in sustainability reports and/or disclosures filed with the SEC. Investors, customers and employees are increasing their focus on ESG issues (such as human capital management and climate issues) and the impact of ESG issues on companies' financial performance. Human capital management covers a broad range of workforce matters, including diversity and inclusion, employee satisfaction and engagement, succession and talent management, and ethics, workforce culture and risk. In August 2020, the SEC adopted rules that require disclosure of any human capital measures or objectives that management focuses on in managing the business (such as those that address the attraction, development and retention of personnel) to the extent material to an understanding of the company's business. This disclosure was first required in companies' 2020 Form 10-Ks filed in early 2021. SEC developments in early 2021 illustrate a heightened focus on climate and ESG-related matters, including momentum toward the SEC developing a comprehensive ESG disclosure framework and increased scrutiny of climate and ESG disclosures (see *Question 5*).
- EEO-1 workforce demographic data. Calls among investors and other stakeholders for disclosure of EEO-1 workforce demographic data have been gaining traction. Disclosure of EEO-1 reports (which provide a racial, gender and job category breakdown of a company's US workforce) would enable measurement and comparison over time between companies and within individual companies. SASB Standards for certain industries recommend disclosure of EEO-1 data and recent shareholder proposals have asked for annual disclosure of EEO-1 data. Beginning in 2022, State Street will vote against compensation committee chairs at S&P 500 companies that do not disclose their EEO-1 Survey responses.
- Board diversity. US public companies are under increasing pressure to enhance the diversity of their boards and related disclosures, and the focus has expanded from gender diversity to ethnic and racial diversity. Certain key institutional investors vote against board members at companies with inadequate board diversity. For more information on the increased pressure to enhance board diversity, including board diversity requirements in California and new Nasdaq requirements, see *Question 7*, *Corporate Directors* and *Diversity*.
- Shareholder derivative litigation linked to diversity efforts. The national focus on racial justice and equity in the US 2020 stemming from the George Floyd killing created a new theory of liability in shareholder litigation, alleging that company directors can violate their duties to the company and shareholders by, among other things, failing to have a sufficiently racially diverse board despite company statements committing to diversity, equity and inclusion. Since summer 2020, more than a dozen shareholder derivative actions alleging this theory have been filed. Three such lawsuits were dismissed in March and April 2021 which may foreshadow whether similar suits will be successful.
- Virtual-only annual shareholders' meetings. The number of US companies that held virtual-only annual shareholders' meetings skyrocketed in 2020 when the COVID-19 pandemic made in-person shareholders' meetings impossible or inadvisable. In April 2020, Institutional Shareholder Services (ISS) issued policy guidance that encouraged companies holding virtual-only meetings to explain why and provide shareholders with a meaningful opportunity to participate fully in the meeting (for example, engage in dialogue, ask questions of directors and senior management). In egregious cases, Glass Lewis may recommend voting against governance committee members or the board chair where a company chooses to hold a virtual-only shareholder meeting and does not provide sufficient disclosure explaining

how shareholders can participate in the meeting and engage with the board and management. Together with investor group the Council of Institutional Investors (CII), several large institutional investors (for example, CalPERS, CalSTRS and the New York City Pension Funds) oppose virtual-only shareholder meetings and may vote against directors at companies that hold them (see *Question 32*).

- Heightened standards for submitting shareholder proposals. The SEC adopted controversial rule amendments in September 2020 that will significantly increase the eligibility requirements for submitting a shareholder proposal to a tiered approach depending on the level of ownership and the relevant holding period:
  - at least USD2,000 if held for at least three years;
  - at least USD15,000 if held for at least two years; and
  - at least USD25,000 if held for at least one year.

- The rule amendments also significantly increase the prior shareholder support thresholds for resubmitting substantially similar shareholder proposals at the same company in future years, and clarify that one person may not submit more than one proposal, directly or indirectly, to a company for the same shareholder meeting. The heightened standards will apply to any shareholder proposal submitted or re-submitted for an annual shareholder meeting held on or after 1 January 2022 and are expected to reduce the number of proposals beginning with the 2022 proxy season.

Corporate Entities

2. What are the main forms of corporate entity used in your jurisdiction?

The main forms of corporate entity used in the US are corporations and limited liability companies. Many large US businesses are corporations with equity and/or debt that trade on either the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq).

Legal Framework

3.Outline the main corporate governance legislation and authorities that enforce it. How influential are institutional investors and other shareholder groups in monitoring and enforcing good corporate governance? List any such groups with significant influence in this area.

State Corporate Laws

State corporate law (statutory and case law) governs:

- The formation of privately held and publicly traded corporations.
- The rights of shareholders and directors in managing the corporation.
- Fiduciary duties of directors and officers.
- Director and officer protections.

The majority of US public companies are incorporated in the state of Delaware. Many other states base their legislation and interpretation on Delaware law (accordingly, the Delaware General Corporation Law (DGCL) is used in this guide as the reference point for all state law discussion). States are also influenced by the Model Business Corporation Act, a model set of law prepared by the American Bar Association. Shareholder suits are the primary enforcement mechanism of state corporate law.

Federal Securities Laws

At the federal level, the primary sources are as follows (each as amended and including the regulations promulgated by the Securities and Exchange Commission (SEC) thereunder):

- The Securities Act of 1933 (Securities Act 1933). The Securities Act 1933 regulates all offerings and sales of securities by public or private companies.
- The Securities Exchange Act of 1934 (Exchange Act 1934). The Exchange Act 1934 addresses specific requirements relating to the periodic disclosure of information by public companies.

Most US federal securities regulation of public company corporate governance is disclosure-driven rather than substantive requirements.

The Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act 2002) provides direct federal regulation of matters that had been left to state corporate law or addressed by federal law through disclosure requirements.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act 2010) extends federal regulation of corporate governance applicable to public companies.

The SEC has promulgated several rules that implement provisions of the Sarbanes-Oxley Act 2002 and the Dodd-Frank Act 2010.

Stock Exchange Listing Rules and Influential Sources of Best Practice Recommendations

To list a security on the NYSE or Nasdaq, a company must agree to abide by the corporate governance requirements provided in the relevant exchange's listing rules.

Corporate governance guidelines and codes of "best practice" recommend how public company boards should organise their structures and processes. Influential recommendations from the business and investor community include:

- American Law Institute (ALI) Principles of Corporate Governance: Analysis and Recommendations.
- National Association of Corporate Directors (NACD) Key Agreed Principles (developed in collaboration with Business Roundtable and the Council of Institutional Investors (CII)) and annual Blue Ribbon Commission reports.
- Business Roundtable, Principles of Corporate Governance.
- Commonsense Principles of Corporate Governance and updated as the Commonsense Principles 2.0. The Commonsense Principles of Corporate Governance (issued in 2016 by a coalition of 13 executives of large public companies and institutional investors and updated in 2018 as the Commonsense Principles 2.0 signed by 23 prominent executives) and the Investor Stewardship Group's Corporate Governance Principles for US Listed Companies and Stewardship Principles (issued in 2017 by a group of US-based institutional investors and global asset managers representing more than USD20 trillion in assets under management) include converging views regarding key board governance, investor stewardship and shareholder engagement issues. A primary theme is that companies should focus more on long-term value creation for shareholders rather than short-term profits. Despite their common themes, the principles reflect general consensus that corporate governance practices and structures must be tailored to the company.
- CII, Corporate Governance Policies.
- California Public Employees' Retirement System, Governance and Sustainability Principles.
- California State Teachers' Retirement System, Corporate Governance Principles.
- TIAA/Nuveen, TIAA Policy Statement on Responsible Investing.
- The Office of the New York City Comptroller, Corporate Governance Principles and Proxy Voting Guidelines.
- Proxy voting policies of large institutional investors such as BlackRock, State Street, Vanguard and Fidelity.

ISS and Glass Lewis have developed influential proxy voting policies based on what they consider to be "best practices." Furthermore, ISS assigns a QualityScore rating to each company that indicates a company's relative risk across specified categories including corporate governance factors and disclosure on environmental and social issues. In addition, in 2020, ISS published a new Climate Voting Policy for investors looking to tailor their engagement practices and/or reconsider their voting decisions based on climate-related practices and disclosures.

4. Has your jurisdiction adopted a corporate governance code?

The US has not adopted a corporate governance code for US companies. Corporate governance matters are provided in state and federal laws, regulations and listing rules.

An influential body of "best practices" literature around corporate governance also exists. It includes recommendations issued by groups such as the NACD, Business Roundtable and CII, as well as proxy voting policies of key institutional investors and proxy advisory firms (see *Question 3*).

Corporate Social Responsibility and Reporting

5. Is it common for companies to report on social, environmental and ethical issues? Highlight, where relevant, any legal requirements or non-binding guidance/best practice on corporate social responsibility.

It is common for companies to report on social, environmental and ethical issues (often referred to as environmental, social and governance (ESG) or corporate social responsibility (CSR) issues).

ESG is no longer a fringe issue of interest only to special issue investors. Mainstream institutional investors are recognising that attention to ESG and CSR impacts portfolio company financial performance. The rising interest in ESG among investors is apparent in the sharp rise over the past several years in US-domiciled assets under management using ESG strategies, increasing support for shareholder proposals relating to ESG issues, as well as in the focus of engagement efforts. In 2020, shareholder proposals relating to environmental and social issues were the most prevalent proposal type for the fourth year in a row and a record number (21) achieved majority support.

The following SEC disclosure requirements tend to trigger disclosure of CSR matters, typically in annual and/or quarterly reports:

- Regulation S-K Item 101: Business description disclosure.
- Regulation S-K Item 103: Legal proceedings disclosure.
- Regulation S-K Item 303: Material known events and uncertainties disclosure included in Management's Discussion and Analysis of Financial Condition and Results of Operations.
- Regulation S-K Item 503(c): Risk factor disclosure.
- SEC Release Nos. 33-9106; 34-61469; FR-82 (8 February 2010): Guidance regarding climate change disclosure.
- Exchange Act Rule 13p-1: Conflict minerals disclosure.

In August 2020, the SEC adopted rules to require the disclosure of any human capital measures or objectives that management focuses on in managing the business (such as those that address the attraction, development and retention of personnel) to the extent material to an understanding of the company's business.

SEC developments in early 2021 illustrate a heightened focus on climate and ESG-related matters, including momentum toward the SEC developing a comprehensive ESG disclosure framework and increased scrutiny of climate and ESG disclosures. The new SEC chair has signalled support for corporate disclosures about political contributions, climate risks and workforce diversity in light of strong investor interest in those topics. In March 2021, the then-acting chair of the SEC invited public comment on public company climate disclosures. Her statement set forth 15 sets of questions that investors, public companies and other market participants can answer to inform the SEC staff as it considers rule amendments aimed at making climate disclosures more consistent, comparable and reliable. Also in March 2021, the SEC created a Climate and ESG Task Force in its Enforcement Division and its Examinations Division announced a greater focus on climate-related risks among its 2021 examination priorities.

Many companies also report on ESG matters voluntarily (for example, 90% of S&P 500 companies published an annual sustainability/responsibility report in 2019). In late 2019, the US Chamber of Commerce released a set of best practices to guide companies in making voluntary disclosure about ESG topics and steer the development of a widely-adopted approach to voluntary ESG reporting without the need for additional regulatory mandates.

Companies can be subject to additional disclosure requirements under state law (for example, certain companies doing business in California are required to disclose measures they take to eliminate slavery and human trafficking in their supply chains).

Many companies consider three influential guides when determining if and what to disclose regarding CSR issues:

- The Global Reporting Initiative Sustainability Reporting Standards.
- The Sustainability Accounting Standards Board (SASB) Implementation Guide.
- The Task Force on Climate-Related Financial Disclosures (TCFD).
- In 2018, ISS launched an Environmental & Social (E&S) QualityScore scoring tool that measures the depth and extent of corporate disclosure on environmental and social issues, including sustainability governance, and identifies key disclosure omissions. This metric for institutional investors to use to evaluate the E&S risk of their portfolio companies has prompted greater disclosure of E&S matters by some US public companies.
- In recent years, large institutional investors have urged companies to disclose how long-term strategy incorporates corporate sustainability considerations. In 2018, State Street sent letters to all companies in the S&P 500 encouraging them to proactively disclose their compliance with the Investor Stewardship Group's corporate governance and sustainability principles. State Street votes against the independent board leader at companies that do not comply with the principles and companies that cannot explain the nuances of their governance structure effectively, either publicly or through engagement.
- In January 2021, BlackRock's chair and CEO released his annual letter (see *www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter*) to the CEOs of its portfolio companies warning that BlackRock will vote against directors at companies that do not make sufficient progress on implementing sustainable business practices and improving their climate change and sustainability-related disclosures. He called for a single global standard for ESG disclosure but, in the meantime, BlackRock continues to endorse the ESG disclosure framework of the SASB and the recommendations of the TCFD. He also noted that BlackRock expects public companies to incorporate climate risk as part of their oversight of long-term strategies and to disclose how they are addressing climate-related risks. Finally, BlackRock asked companies to disclose in their sustainability reports their long-term strategies for improving diversity, equity and inclusion.
- Also in January 2021, the president and CEO of State Street Global Advisors sent a letter (*www.ssga.com/us/en/institutional/ic/insights/ceo-letter-2021-proxy-voting-agenda*) to the boards of its portfolio companies announcing that State Street will prioritize systemic risks associated with climate change and a lack of racial and ethnic diversity – and will hold boards and management accountable for enhancing disclosures on these topics. State Street will continue to engage with companies in the S&P 500 and certain other indices that lag behind their peers in State Street's "R-Factor" score (used to measure company performance in business operations and governance related to financially material and industry-specific ESG issues). Specifically, State Street will ask companies especially vulnerable to the transition risks of climate change about their plans to mitigate and manage the physical and transitional impacts of climate change. The letter also discussed State Street's recent efforts to proactively address racial and ethnic diversity, including through the issuance of new Guidance on Enhancing Racial and Ethnic Diversity Disclosures (*www.ssga.com/library-content/pdfs/asset-stewardship/racial-diversity-guidance-article.pdf*) and related proxy voting guidelines. Beginning in 2021, State Street will vote against nominating and governance committee chairs at S&P 500 companies that do not disclose the racial and ethnic composition of their boards. Beginning in 2022, State Street will vote against

compensation committee chairs at S&P 500 companies that do not disclose their EEO-1 Survey responses (referring to a disclosure framework set forth by the US Equal Employment Opportunity Commission that tracks employee diversity by race, ethnicity and gender, broken down by industry, employment categories or seniority levels, for all full-time US employees). Finally, beginning in 2022, State Street will vote against nominating and governance committee chairs at S&P 500 companies that do not have at least one director from an underrepresented community on their boards.

Board Composition and Restrictions

6. What is the management/board structure of a company?

Structure

US public companies predominantly have a unitary board structure (that is, one tier).

Management

Section 141 of the DGCL states that "the business and affairs of every corporation…shall be managed by or under the direction of a board of directors, except as may be otherwise provided … in its certificate of incorporation." The board generally delegates the day-to-day operation of the business to the chief executive officer (CEO) and other senior executives. The board provides oversight of management.

Board Members

Shareholders elect natural persons to serve as directors. The NYSE and Nasdaq listing rules require that a majority of directors be independent.

Employees' Representation

Employees are not entitled to board representation.

Number of Directors or Members

Section 141(b) of the DGCL requires that the board consist of one or more members. The number of directors is set by the corporation's certificate of incorporation or bye-laws. Typically, the bye-laws will specify a range and the board will fix the exact number of directors by resolution.

ISS considers a board size of between nine and 12 directors "ideal" and has stated that a company must have no less than six and no more than 15 directors.

7. Are there any general restrictions or requirements on the identity of directors?

General Restrictions

There are no relevant general restrictions.

Age

Delaware law does not impose an age requirement on directors. However, some company bye-laws require that directors be at least 18 years of age. Further, 70% of S&P 500 boards disclosed a mandatory retirement age for directors in 2020, with the age of 75 being the most common limit (source: 2020 Spencer Stuart Board Index).

Nationality

State corporate law does not impose nationality or residency requirements on directors. In certain regulated industries, all or a minimum number of directors could be required to be US citizens and/or residents of the US or the state in which the corporation is incorporated.

Corporate Directors

Only natural persons can be directors.

Diversity

Boards of US public companies are not generally subject to gender quotas. However, in 2018, a California law was enacted that required California-based publicly held domestic or foreign corporations to have at least one female director by the end of 2019, and (depending on board size) up to three female directors by the end of 2021. A similar California law was enacted in September 2020 that will require such corporations to have at least one director from an underrepresented community by the end of 2021, and (depending on board size) up to three directors from underrepresented communities by the end of 2022. Several other states have enacted or are considering legislation that would encourage greater board diversity or require disclosure about board diversity, including Colorado, Hawaii, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Pennsylvania, and Washington.

The SEC rules require companies to disclose whether and (if so) how the nominating committee considers diversity in identifying director nominees, and if a diversity policy exists. Under SEC guidance issued in 2019, if the board or nominating committee considered certain self-identified diversity characteristics (such as race, gender, ethnicity, religion, nationality, disability, sexual orientation or cultural background) when determining an individual's specific experience, qualifications, attributes or skills for board membership, then the SEC expects the company to disclose those characteristics and how they were considered in the nomination process. The guidance also requires a company to disclose how its diversity policy (if any) takes into account nominees' self-identified diversity attributes and any other qualifications (such as diverse work experiences, military service or socio-economic or demographic characteristics).

In October 2019, the Office of the New York City Comptroller launched an initiative urging public companies to adopt a diversity search policy requiring that:

- Qualified female and racially/ethnically diverse candidates be included in the pool of nominees from which directors and CEOs are selected.
- Director searches include candidates from non-traditional backgrounds such as government, academic or non-profit organisations.

State Street Global Advisors published guidance in 2017 indicating that it may vote against the chair of a nominating or governance committee of a company that has no female directors and fails to take action to increase the number of women on its board. Consistent with this guidance, in recent years State Street has voted against or withheld votes from nominating and governance committee chairs at hundreds of its portfolio companies with no female directors. Beginning in 2021, State Street will vote against nominating and governance committee chairs at S&P 500 companies that do not disclose the racial and ethnic composition of their boards. Beginning in 2022, State Street will vote against nominating and governance committee chairs at S&P 500 companies that do not have at least one director from an underrepresented community on their boards.

BlackRock issued updated proxy voting guidelines in 2018 stating its expectation for the US public companies in which it invests to have at least two female directors and noting that it may vote against nominating and governance committee members at a company BlackRock believes "has not adequately accounted for diversity in its board composition".

Effective as of 2020, ISS generally recommends voting against nominating committee chairs (and potentially other directors) at companies with no female directors unless certain mitigating factors apply. Glass Lewis adopted a similar policy that took effect for the 2019 proxy season. Beginning in 2022, Glass Lewis will recommend voting against nominating committee chairs at companies where a board with more than six members has fewer than two female directors. Beginning in 2022, ISS will recommend voting against nominating committee chairs at companies that have no racially/ethnically diverse directors, with certain exceptions.

For 2021, Glass Lewis revised its policy to indicate that when evaluating board diversity it will make recommendations in accordance with board composition requirements set out in any applicable state laws on diversity that take effect. Specifically, beginning in 2022, Glass Lewis will base its vote recommendations at California-based companies on compliance with the applicable board diversity thresholds then in effect.

Since July 2020, Goldman Sachs will not take a company public unless it has at least one diverse board candidate, "with a focus on women". Beginning in 2021, Goldman Sachs Asset Management will vote against the entire board at any company with no female directors, and against all nominating committee members at any company that does not have at least one female director and one additional diverse director based on gender identity, sexual orientation and racial or ethnic background.

Finally, in August 2021, the SEC approved changes to the Nasdaq listing rules related to board diversity. Once effective, the amended rules will require each Nasdaq-listed company, subject to certain exceptions, to:

- Publicly disclose in an aggregated form, to the extent permitted by applicable law and within one year of the 6 August 2021 approval date, information on the voluntary self-identified gender and racial characteristics and LGBTQ+ status of the company's board of directors.
- Have, or explain why it does not have, at least two directors who are diverse, including:
    - at least one director who self-identifies as female; and

    - at least one director who self-identifies as an underrepresented minority or LGBTQ+.

- Companies will be required to have at least one diverse director within two years of the 6 August 2021 approval date and two within four to five years, depending on the size of the company and their stock market exchange tier. A Nasdaq-listed company with a board of five or fewer members will be required to have, or explain why it does not have, at least one diverse director.

For purposes of the new rules the following definitions apply:

- "Diverse" means an individual who self-identifies as a female, an underrepresented minority and/or LGBTQ+.
- "Female" means an individual who self-identifies her gender as a woman, without regard to the individual's designated sex at birth.
- "Underrepresented minority" means an individual who self-identifies as one or more of the following: Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, or Two or More Races or Ethnicities.
- "LGBTQ+" means an individual who self-identifies as any of the following: lesbian, gay, bisexual, transgender, or as a member of the queer community.

Interlocks

No person can simultaneously serve as an officer or a director of competing corporations if the corporations are engaged in commerce and have capital, surplus and profits above certain thresholds (*section 8, Clayton Antitrust Act of 1914*).

The Depository Institution Management Interlocks Act generally prohibits a director of a depository organisation from simultaneously serving as a director of an unaffiliated depository organisation in situations where the interlock likely would have an anticompetitive effect.

8. Are non-executive, supervisory or independent directors recognised or required?

Recognition

The SEC rules require public companies to disclose the names of independent directors.

Board Composition

The NYSE and Nasdaq listing rules require that independent directors comprise a majority of the board and serve on the audit, compensation and nominating/corporate governance committees (with some exemptions, including transition periods for newly public companies and cure periods during which companies can regain compliance).

Independence

Under NYSE listing rules, for a director to qualify as "independent," the board must affirmatively determine that the director has no material relationship with the company including relationships that are (among others):

- Commercial.
- Industrial.
- Banking.
- Consulting.
- Legal.
- Accounting.
- Charitable.
- Familial.

A director cannot be considered independent if he or she:

- Is an employee of the listed company or is an immediate family member of an executive officer of the listed company.
- Receives, or is an immediate family member of a person who receives, compensation directly from the listed company, other than director compensation or pension or deferred compensation for prior service (provided the compensation is not contingent in any way on continued service), of more than USD120,000 per year.
- Is a partner or employee of (or is an immediate family member of a person who is a partner of, or employed (and works on the listed company's audit) by) a present or former internal or external auditor of the listed company.
- Is or has been (or is an immediate family member of a person who has been) part of an interlocking compensation committee arrangement.
- Is an employee or is an immediate family member of an executive officer, of a company that makes payments to or receives payments from the listed company for property or services in an amount that in any of the last three fiscal years exceeds the greater of 2% of the other company's consolidated gross revenues or USD1 million.

In applying the independence criteria, an individual who has had a relationship as described above within the past three years cannot be considered independent (except for the test in the final bullet point which covers only current employment relationships). Nasdaq listing rules take a similar approach to defining independence.

Audit committee members of NYSE and Nasdaq companies must satisfy additional, heightened standards of independence. Under NYSE and Nasdaq rules, in affirmatively determining the independence of any director who will serve on the compensation committee, the board must consider all factors specifically relevant to determining whether a director has a relationship to the company which is material to the director's ability to be independent from management in connection with the duties of a compensation committee member, including:

- Any compensatory fee paid by the company to the director.

- Whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

Companies can also impose their own standards of independence, which must be disclosed.

ISS and Glass Lewis each apply different definitions and thresholds when assessing director independence.

9. Are the roles of individual board members restricted?

Individual board members of listed companies who serve on key committees must be independent (see *Question 8*).

The board determines its own leadership structure in accordance with the charter and bye-laws. Board leadership structure can take various forms, for example:

- Combined chair/CEO.
- Separate chair (who can be executive or non-executive, non-independent or independent) and CEO.
- Lead independent director, with responsibilities determined by the board.

SEC rules require disclosure of whether and why the board has chosen to combine or separate the board chair and CEO roles. Where the positions are combined, the company must disclose whether and why the company has a lead independent director, and the specific role the lead independent director plays in the leadership of the company.

10. How are directors appointed and removed? Is shareholder approval required?

Appointment of Directors

Election. Under state corporate law, shareholders generally have the right to elect directors at the annual shareholder meeting (*sections 211 and 216, DGCL*). Companies also adopt bye-laws authorising the board to elect directors to fill board vacancies and newly created directorships.

The statutory default is for plurality voting in uncontested director elections. Most large companies, however, have adopted some form of majority voting in uncontested director elections (89% of S&P 500 companies in 2020, up from 71% in 2010 and just 16% in 2006 (source: 2020 Spencer Stuart Board Index)).

Nomination. The board generally nominates director candidates, which is required to be done by an independent nominating committee for the NYSE and the Nasdaq-listed companies. Nasdaq, however, permits director nominations by independent directors without a formal committee.

Shareholders can also nominate director candidates either before or at a shareholder meeting if certain conditions are met, including, without limitation, compliance with advance notice and/or proxy access bye-laws (see *Question 35*).

Removal of Directors

Shareholders generally have the right to remove directors with or without cause. However, where the board is classified, shareholders can only remove directors with cause (unless the certificate of incorporation provides otherwise).

The holders of a majority of the shares that are entitled to vote at an election of directors can remove a director (subject to limited exceptions, such as where the company has cumulative voting) (*section 141(k), DGCL*). However, this power can be difficult to exercise in practice as many companies do not permit shareholders to call special meetings or act by written consent.

Directors can also be removed via judicial proceedings. Generally a board is highly constrained in its ability to remove a director.

11. Are there any restrictions on a director's term of appointment?

Directors are typically elected annually. Directors of companies with a classified board can be elected every three years (*section 141(d), DGCL and NYSE listing rules*).

A small number of large US public companies have imposed director term limits (for example, 6% of S&P 500 companies disclosed a term limit in 2020 (source: 2020 Spencer Stuart Board Index)). While most institutional investors do not support director term and age limits, some are of the view that long-tenured directors are not independent.

Directors' Remuneration

12. Do directors have to be employees of the company? Can shareholders inspect directors' service contracts?

Directors Employed by the Company

Directors are not required to be employees of the company. Generally, the CEO is the only employee who serves on the board. As discussed in *Question 8*, according to the NYSE or the Nasdaq listing rules, to be considered independent, the director cannot be, nor have been within the last three years, an employee of the corporation.

Shareholders' Inspection

US public companies do not normally enter into service contracts with their directors. Companies must file with the SEC any agreements with a director (for example, indemnification agreements which are publicly available on the SEC website). Shareholders can also find information about directors' responsibilities, compensation and transactions with the company in the company's governance policies and SEC filings.

13. Are directors allowed or required to own shares in the company?

Directors are not required by law to own shares in the corporation (*section 141(b), DGCL*). Many companies grant equity to directors (in addition to cash retainers and other benefits) to compensate them for director service.

Share ownership by directors is often required by companies' corporate governance guidelines (or bye-laws). These guidelines require directors to own a specified amount of the company's shares (or other equity) within a certain amount of time after joining the board.

14. How is directors' remuneration determined? Is its disclosure necessary? Is shareholder approval required?

Determination of Directors' Remuneration

Generally, the board determines the amount and type of director compensation (usually upon the recommendation of the compensation or nominating/governance committee).

In determining the appropriate amount and type of director compensation, many boards (and/or committees) take into account advice provided by independent compensation consultants.

Disclosure

Public companies must annually disclose director compensation for the prior fiscal year (including fees, stock and option awards and other benefits) in a tabular format, along with a narrative description of the information in the table. The NYSE requires listed companies to adopt and disclose corporate governance guidelines which address director compensation. Since 2016, Nasdaq-listed companies must disclose compensatory arrangements between directors or nominees and third parties in connection with that person's candidacy or service as a director (known as "golden leashes").

Shareholder Approval

NYSE and Nasdaq listing rules require companies to obtain shareholder approval of equity plans applicable to directors. Companies are not required to seek shareholder approval of cash compensation or specific equity grants awarded to directors.

General Issues and Trends

Boards must exercise caution when approving equity compensation plans that permit equity awards to be made to non-employee directors. In light of recent Delaware litigation, companies should adhere to a robust process in determining director compensation, such as reviewing peer company practices and engaging compensation consultants.

Proxy advisory firms do not scrutinise director compensation to the same extent as executive compensation. However, ISS' QualityScore governance rating for each company reports the average outside directors' total compensation for the prior year as a multiple of the median pay of the company's ISS-determined comparison group for the same period. Furthermore, since 2020, ISS will potentially issue adverse vote recommendations against board members responsible for setting or approving excessive non-employee director compensation (for example, above the top 2% of all comparable directors) in two or more consecutive years without a compelling rationale or mitigating factors.

Management Rules and Authority

15. How is a company's internal management regulated? For example, what is the length of notice and quorum for board meetings, and the voting requirements to pass resolutions at them?

The certificate of incorporation and bye-laws generally regulate a company's internal affairs. If the governing documents are silent, default rules under the relevant state law apply.

The DGCL is silent with respect to notice for board meetings. Consequently, any applicable requirements will be as provided in the company's bye-laws and/or corporate governance guidelines. Boards typically schedule regular meetings a year in advance and provide materials a week before the meeting. Special meetings are scheduled on an ad hoc basis and notice is provided several days before the meeting.

Section 141(b) of the DGCL provides that a majority of the total number of directors will constitute a quorum, unless the certificate of incorporation or bye-laws specify a greater or lesser quorum requirement (but not less than one third of the board). The vote of a majority of directors present at a meeting at which a quorum is present will be the act of the board (unless the certificate of incorporation, the bye-laws or the DGCL provide otherwise). A lower quorum can apply and officers can substitute for directors for quorum purposes in the event of an emergency, under DGCL default provisions or emergency bye-laws (*section 110, DGCL*).

Section 141(f) of the DGCL permits the board or any board committee to act without a meeting (so long as all members consent in writing or by electronic transmission), unless such action is restricted by the certificate of incorporation or bye-laws.

16. Can directors exercise all the powers of the company or are some powers reserved to the supervisory board (if any) or a general meeting? Can the powers of directors be restricted and are such restrictions enforceable against third parties?

Directors' Powers

The board is responsible for managing and directing the business and affairs of the company except as may be provided in the certificate of incorporation (*section 141(a), DGCL*). Generally, state law and the certificate of incorporation provide that directors can exercise all of the powers of the company. Boards typically delegate day-to-day responsibility for managing the company to management. The most critical powers of directors include selecting the CEO and overseeing senior management's performance in executing the company's strategy and managing risk.

Shareholders of US public companies have decision-making rights with respect to certain key matters:

- Director elections and removal of directors.
- Amendments to the certificate of incorporation.
- Amendments to the bye-laws (the board also typically has the right to amend bye-laws).
- Significant corporate transactions (such as mergers, sale of all or substantially all of the corporation's assets and dissolution).
- Advisory votes on executive compensation.
- Advisory or binding votes on shareholder proposals.
- Equity compensation plans and certain share issuances that exceed specified thresholds or would result in a change of control of the company (where listed on the NYSE or Nasdaq).
- Auditor ratification (common but not required by law).

Other issues that may be brought to shareholder vote include:

- Approval of certain business combinations with interested shareholders that would otherwise be prohibited.
- Approval of conversion to a different type of entity.
- Approval of transfer, domestication or continuance in a foreign jurisdiction.
- Approval of dissolution and revocation of dissolution.
- Ratification of defective corporate acts that would have required shareholder approval.

Shareholders may also be asked by the board to approve certain matters, including:

- Approval of interested director or officer transactions.
- The making of determinations that indemnifying a director or officer is proper.

- The making of determinations that the consideration for which shares of stock with or without par value may be issued, and treasury stock disposed of (if provided in the certificate of incorporation).

Restrictions

The certificate of incorporation and bye-laws can restrict the powers of directors.

17. Can the board delegate responsibility for specific issues to individual directors or a committee of directors? Is the board required to delegate some responsibilities, for example for audit, appointment or directors' remuneration?

Boards can delegate certain responsibilities to board committees. A board can, by resolution passed by a majority of the whole board, designate one or more committees, each consisting of at least one director. To the extent provided in the board resolution or the bye-laws, any of these committees can exercise all the powers and authority of the board. However, the board cannot delegate the power to:

- Adopt, amend or repeal any bye-law.
- Amend the certificate of incorporation (however, a board committee can make certain specified decisions relating to the rights, preferences or issuance of authorised stock, to the extent specifically delegated by the board).
- Adopt an agreement of merger or consolidation.
- Recommend to shareholders the sale, lease or exchange of all or substantially all of the company's property and assets.
- Recommend to shareholders dissolution of the company or a revocation of dissolution.
- Approve, adopt or recommend to shareholders any action or matter that is required to be submitted to shareholders for approval.
- Declare a dividend (unless that power is expressly provided for in the certificate of incorporation, resolution or bye-laws).
- Authorise the issuance of stock or adopt a certificate of ownership and merger (unless that power is expressly provided for in the certificate of incorporation, resolution or bye-laws).

(*Section 141(c), DGCL.*)

Boards of US public companies delegate responsibilities for audit, nomination of directors and compensation to board committees. The Sarbanes-Oxley Act 2002 and the NYSE and Nasdaq listing rules require each company to have an audit committee comprised of independent directors that is responsible for certain audit and financial reporting matters. NYSE and Nasdaq listing rules require audit committee members to be financially literate and at least one member to be financially sophisticated.

As required by the Dodd-Frank Act, NYSE and Nasdaq listing rules provide that each company must have a compensation committee comprised of independent directors that is responsible for certain matters relating to executive compensation.

NYSE listing rules require that each company have a nominating/governance committee comprised of independent directors who are responsible for director nominations and corporate governance.

Nasdaq listing rules require independent directors (or a committee of independent directors) to have responsibility for certain decisions relating to director nominations.

These committees are generally permitted to delegate their responsibilities to subcommittees solely comprised of one or more members of the relevant committee.

Director's Duties and Liabilities

18. What is the scope of a director's general duties and liability to the company, shareholders and third parties?

Fiduciary Duties

Directors owe fiduciary duties of care and loyalty to the company and its shareholders:

- Duty of care. The duty of care requires directors to act with the degree of care that an ordinarily prudent person in a like position would use under similar circumstances. The duty of care requires directors to act on an informed basis, after reasonable inquiry and deliberation. Directors are permitted to rely on management and experts where it is reasonable to do so.
- Duty of loyalty. The duty of loyalty requires directors to act in good faith and in a manner the director reasonably believes to be in the best interests of the company and its shareholders. The duty of loyalty prohibits self-dealing and misappropriation of assets or opportunities and requires directors to keep information confidential.
- The duty to act in good faith is a subsidiary element of the duty of loyalty. Generally, that duty requires directors to act honestly and sincerely, in the best interest of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy.
- The duty of directors to provide oversight is based on the concept of good faith. In the oversight context, courts focus on whether the board has taken adequate steps to determine that the corporation's business and affairs are being properly administered by the company's officers and management. Boards are expected to ensure that reasonable information and reporting systems are implemented and maintained to provide the board and senior management with timely, accurate information to support informed decisions and so directors can reach informed judgments concerning the corporation's performance.
- In four recent instances, a Delaware court declined to dismiss a claim alleging that directors had not satisfied their duty to exercise oversight. In one case, the Delaware Supreme Court found that the plaintiff adequately pled that the directors failed to implement any monitoring or reporting system related to the most central safety and legal compliance risk facing the company (*Marchand v Barnhill, 212 A.3d 805, Del 18 June 2019*). In another case, the

Delaware Chancery Court found that the plaintiff adequately pled that the directors failed to appropriately monitor compliance systems and controls (*In re Clovis Oncology Inc Derivative Litig., Del Ch 1 October 2019*). That decision suggests that Delaware courts will impose a higher standard on directors of companies operating in the midst of mission critical regulatory compliance risk. In addition, the Delaware Chancery Court found that the claimant adequately pled that the directors failed to make a good faith effort to put in place a board-level system for monitoring the company's financial reporting (*Hughes v Hu, Del Ch, 27 April 2020*). Finally, the Delaware Chancery Court found that the claimants adequately stated a "*Caremark*" claim for oversight liability in a case involving board failure to remediate legal issues disclosed in public filings (*Teamsters Local 443 Health Services & Insurance Plan v Chou, Del Ch, 24 August 2020*).

Directors' Liability

Directors are subject to liability for their actions and inactions, but broad protections from liability typically apply. Courts will generally apply the business judgement rule which presumes that the directors and officers acted on an informed basis, in good faith and in the best interest of the company. If the plaintiff does not overcome the presumption, the court will not investigate the merits of the underlying board decision.

In certain contexts (such as sale of the company) a different standard of judicial review can apply. Directors are normally protected by governing document provisions that require exculpation from liability, indemnification and advancement of expenses, as well as directors' and officers' insurance.

19. Briefly outline the regulatory framework for theft, fraud, and bribery that can apply to directors.

Directors can be criminally liable under state and federal laws for actions that constitute theft, fraud or bribery. For example, a director can face sanctions for violating the Foreign Corrupt Practices Act (FCPA) which prohibits bribes to foreign officials for purposes of influencing a decision or securing an improper advantage to assist the company in obtaining or retaining business.

20. Briefly outline the potential liability for directors under securities laws.

Directors can face civil and criminal liability for violations of state and federal securities laws. For example, a director can be liable for (*rule 10b-5, Exchange Act 1934 and section 11, Securities Act 1933*):

- Material misrepresentations and material omissions in security offering documents.
- Insider trading and market manipulation.

21. What is the scope of a director's duties and liability under insolvency laws?

If a company becomes insolvent, directors continue to owe fiduciary duties to the company, but not directly to creditors. However, creditors of an insolvent company have standing to assert derivative (but not direct) claims against directors for breach of fiduciary duties (*North American Catholic Educational Programming Foundation Inc v Gheewalla, 930 A.2d (Del 18 May 2007)*).

When operating in the zone of insolvency, directors must continue to discharge their fiduciary duties to the company and its shareholders by exercising their business judgement in the best interests of the company and for the benefit of its shareholders. Directors can, as a matter of business judgement, favour certain non-insider creditors over others of similar priority without breaching their fiduciary duties.

22. Briefly outline the potential liability for directors under environment and health and safety laws.

Under certain circumstances, directors can be held personally liable for violations of environmental and health and safety laws, including:

- The Comprehensive Environmental Response.
- Compensation and Liability Act.
- Occupational Safety and Health Act.
- Clean Air Act and Clean Water Act.

Liability will vary depending on a director's knowledge or intent.

23. Briefly outline the potential liability for directors under anti-trust laws.

The primary federal anti-trust laws in the US include:

- The Sherman Act.

- The Federal Trade Commission Act.
- The Clayton Act.
- The Hart Scott Rodino Act.

In addition, most states have anti-trust laws that are enforced by state attorneys general or private plaintiffs.

Directors can be subject to significant liability for anti-trust law violations including:

- Criminal prosecution (typically limited to intentional and clear violations).
- Civil suits by the US or private citizens for an injunction or damages.
- Derivative actions by shareholders.

24. Briefly outline any other liability that directors can incur under other specific laws.

In some states, directors can be held personally liable for unpaid employee wages and other violations of wage and hour laws (for example, California's A Fair Day's Pay Act 2016).

25.Can a director's liability be restricted or limited? Is it possible for the company to indemnify a director against liabilities?

Companies normally include a provision in the certificate of incorporation eliminating or limiting the personal liability of directors to the company or shareholders for monetary damages for breach of fiduciary duty as a director (*section 102(b)(7), DGCL*). This provision cannot eliminate or limit director liability for:

- Any breach of the duty of loyalty.
- Acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.
- Unlawful payments of dividends or unlawful stock purchases or redemptions.
- Any transaction from which the director derived an improper personal benefit.

Companies typically indemnify directors for liability incurred so long as the director (*Section 145, DGCL*):

- Acted in good faith.
- Acted in a manner that he or she reasonably believed was in the best interests of the company.
- In the case of a criminal proceeding, had no reasonable cause to believe his or her conduct was unlawful.

26. Can a director obtain insurance against personal liability? If so, can the company pay the insurance premium?

Companies typically purchase and maintain directors' and officers' liability insurance to protect directors against the risk of personal liability (*section 145(g), DGCL*). Companies can, and usually do, pay the insurance premiums on behalf of directors.

27. Can a third party (such as a parent company or controlling shareholder) be liable as a de facto director (even though such person has not been formally appointed as a director)?

A shareholder's liability for corporate actions is generally limited to the amount of its equity investment in the company. However, courts can "pierce the corporate veil" to impose personal liability on the shareholders in exceptional circumstances, such as where the corporate form is being used as a sham to perpetrate a fraud or to avoid liability.

Controlling shareholders can also owe fiduciary duties of fair dealing to the company and minority shareholders.

Transactions with Directors and Conflicts

28. Are there general rules relating to conflicts of interest between a director and the company?

Directors owe a duty of loyalty to the company and its shareholders. This duty prohibits self-dealing and misappropriation of assets or opportunities. Directors cannot use their position to make a personal profit or achieve personal gain. The duty of loyalty requires directors to disclose any conflicts of interest. The board should recuse conflicted directors from board discussions and decision-making relating to the conflict. A self-dealing transaction is not voidable if:

- It is approved by informed and disinterested directors.

- It is approved by informed shareholders.
- The transaction is fair to the company as of the time it is authorised, approved or ratified by directors or shareholders.

(*Section 144, DGCL*.)

29. Are there restrictions on particular transactions between a company and its directors?

Section 402 of the Sarbanes-Oxley Act 2002 prohibits companies from extending or maintaining personal loans to directors, with certain exceptions (for example, loans made by FDIC-insured institutions and ordinary course of business loans made by consumer lenders). Transactions with the company can also impact a director's independence (see *Question 7*).

30. Are there restrictions on the purchase or sale by a director of the shares and other securities of the company he/she is a director of?

In general, directors are not restricted from purchasing or selling shares and other securities of the company. However:

- A director is prohibited from trading in a company's securities when in possession of material, non-public information about the company (*rule 10b-5, Exchange Act 1934*).
- Companies generally have policies that impose black-out periods and otherwise regulate trading in the company's stock by directors and officers (for example, by requiring pre-clearance of trades).
- The public resale of directors' shares is not permitted unless certain conditions are met, such as specified holding periods and volume limitations (*rule 144, Securities Act 1933*).
- Directors must disclose their shareholdings and any transactions that result in a change in their share ownership (*section 16, Exchange Act 1934*).
- Directors must disgorge to the company any profits realised on the purchase and sale of the company's securities within a period of less than six months ("short-swing" profits) (*section 16, Exchange Act 1934*).
- Many companies prohibit directors from pledging and/or hedging company stock.

Disclosure of Information

31. Do directors have to disclose information about the company to shareholders, the public or regulatory bodies?

Directors are required to sign certain disclosure documents the company files with the SEC (for example, the annual report on Form 10-K).

Directors are increasingly involved in communicating with shareholders (for example, via shareholder engagement meetings or telephone calls and/or letters from the board that are included in the proxy statement).

Shareholder Rights

Company Meetings

32. Does a company have to hold an annual shareholders' meeting? If so, when? What issues must be discussed and approved?

Most states require companies to hold an annual shareholders' meeting, (for example, for the election of directors), to be held at a date, time, and place prescribed or determined in accordance with the company's certificate of incorporation or bye-laws (*section 211(b), DGCL*). Typically, the board determines when and where to hold the meeting, including whether a meeting should be held at a physical location, virtually or both.

Before 2020, a small but growing number of US companies held virtual annual shareholders' meetings, typically in one of two formats:

- Exclusively online with no ability for a shareholder to attend an in-person meeting.
- Hybrid approach, where an in-person meeting is held that is open to online participation by shareholders who are not physically present at the meeting.

The primary benefits of virtual shareholders' meetings are increased shareholder participation and cost savings.

The number of US companies that held virtual-only annual shareholders' meetings skyrocketed in 2020 when the COVID-19 pandemic made in-person shareholders' meetings impossible or inadvisable. Some states limit the ability of companies to hold a virtual-only annual meeting, although the governors of several of those states have issued executive orders permitting such meetings during the state of emergency caused by COVID-19. Many US companies are considering holding annual shareholders' meetings in a virtual-only or in a hybrid format in the future.

Currently ISS prefers a hybrid approach but does not have a policy to recommend voting against directors at companies that hold virtual-only meetings. In April 2020, ISS issued policy guidance that encouraged companies holding virtual-only meetings to explain why and provide shareholders with a meaningful opportunity to participate fully in the meeting (for example, engage in dialogue, ask questions of directors and senior management).

In egregious cases, Glass Lewis may recommend voting against governance committee members or the board chair where a company chooses to hold a virtual-only shareholders' meeting and does not provide sufficient disclosure explaining how shareholders can participate in the meeting and engage with the board and management.

Together with CII, several large institutional investors (for example, CalPERS, CalSTRS and the New York City Pension Funds) oppose virtual-only shareholders' meetings and may vote against directors at companies that hold them.

The NYSE requires companies to hold an annual shareholders' meeting during each fiscal year. Nasdaq requires each company to hold an annual shareholders' meeting no later than one year after the end of the company's prior fiscal year.

In addition to director elections, "any other proper business may be transacted at the annual meeting" under the DGCL. Common agenda items include:

- Ratification of the appointment of the independent auditor.
- Approval of equity compensation plans.
- Approval of proposed amendments to the certificate of incorporation.
- Shareholder proposals (advisory or binding).
- An advisory vote on executive compensation (say-on-pay).

33. What are the notice, quorum and voting requirements for holding meetings and passing resolutions?

Companies must notify shareholders of shareholder meetings within a fixed number of days before the meeting date; the number varies according to state law. In Delaware, companies must provide notice to shareholders, in a maximum of 60 and a minimum of ten days, before the date of the annual meeting (*section 222, DGCL*). Shareholders can waive notice under certain circumstances, such as by signing a written waiver or attending the meeting.

Notice must generally be in writing, although many states permit electronic transmission. A notice of an annual meeting need not specify the meeting's purposes except when fundamental corporate actions (for example, merger or dissolution) are to be voted on. A notice of special meeting must specify the purpose for which the meeting is being called.

State law generally allows companies to establish a record date to determine who is eligible to receive notice and vote at a shareholder meeting. The record date for Delaware companies must be a maximum of 60 and a minimum of ten days before the meeting date (*section 213, DGCL*).

The bye-laws prescribe the quorum necessary for valid shareholder action to be taken at a meeting, which in Delaware must be at least one-third of the shares entitled to vote at the meeting. If the governing documents are silent, state law typically provides that a majority of shares entitled to vote, present or represented by proxy, constitutes a quorum at a meeting of shareholders (*section 216, DGCL*). Director elections are by plurality voting under the statutory default. However, most large companies have adopted some form of majority voting in uncontested director elections.

Shareholders can also act by written consent in lieu of a meeting at some companies; under the DGCL, this is a default right but many companies opt out in the certificate of incorporation (*section 228, DGCL*). The threshold for written consent may be the same number of shareholders necessary to take action at a meeting (under the statutory default) or unanimous (if so provided in the certificate of incorporation). If shareholders act by less than unanimous written consent, the company must provide notice of the action taken to all shareholders.

34. Are specific voting majorities required by statute for certain corporate actions?

The shareholder vote required to approve a corporate action is typically provided in the certificate of incorporation or bye-laws, in accordance with state law. The DGCL requires a majority shareholder vote to:

- Amend the certificate of incorporation (*section 242, DGCL*).
- Approve a merger or sale of assets (*sections 271 and 251, DGCL*).
- Effect a dissolution of the company (*section 275, DGCL*).

Companies can set a higher percentage than the default statutory standards.

35. Can shareholders call a meeting or propose a specific resolution for a meeting? If so, what level of shareholding is required to do this?

Shareholders can call special meetings if authorised by, and subject to, the certificate of incorporation or bye-laws (*section 211, DGCL*). State law generally permits shareholders to petition the court to compel an annual shareholder meeting if the board failed to hold one.

A shareholder eligible to bring matters before a shareholder meeting (including advance notice requirements) can also, at his or her own expense, solicit shareholder proxies in favour of any proposal, subject to the federal proxy rules.

Public companies must include proposals submitted by qualified shareholders in their proxy materials (*rule 14a-8, Exchange Act 1934*). To be eligible, a shareholder must have continuously held at least USD2,000 in market value or 1% of the company's securities that are entitled to vote for at least one year by the date he or she submits the proposal, and hold those securities until the meeting date. Amendments to this threshold will apply to any shareholder proposal submitted or re-submitted for an annual shareholder meeting held on or after 1 January 2022 (see *Question 1*).

More than 80% of S&P 500 companies have adopted a proxy access bye-law which permits shareholders or a group of shareholders with beneficial ownership of typically 3% for three years and meeting certain conditions, to include a limited number of director candidates in the company's proxy materials.

Minority Shareholder Action

> 36. What action, if any, can a minority shareholder take if it believes the company is being mismanaged and what level of shareholding is required to do this?

A minority shareholder can take the following actions if it believes the company is being mismanaged:

- Inspect the books and records of the company (*section 220, DGCL*).
- Engage in activism, for example, by:
  - waging a proxy contest (to nominate a director or replace members of the board or the corporation's management);
  - filing a shareholder proposal (*rule 14a-8, Exchange Act 1934*); and/or
  - engaging with management and/or the board.
- File a derivative action (that is, in the name of the company) alleging director misconduct.
- File a direct action.

Internal Controls, Accounts and Audit

> 37. Are there any formal requirements or guidelines relating to the internal control of business risks?

Public companies must include in annual reports on Form 10-K, an internal control report that includes (*section 404, Sarbanes-Oxley Act 2002*):

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year.
- A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting (for example, Internal Control – Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission).
- A statement that the independent auditor has issued an attestation report on management's assessment of the company's internal control over financial reporting.

In addition, the CEO and the chief financial officer must provide quarterly certifications in relation to internal control over financial reporting.

The Foreign Corrupt Practices Act (FCPA) requires companies to have a system of internal accounting controls sufficient to provide reasonable assurances that:

- Transactions are properly authorised and recorded.
- Access to assets is properly authorised.

38. What are the responsibilities and potential liabilities of directors in relation to the company's accounts?

Directors can face civil and criminal liability based on violations of state and federal securities laws for fraudulent misrepresentation or material omissions in documents that are filed with the SEC.

Any director who makes or causes the making of a false or misleading statement in a document filed with the SEC (including those in relation to the company's accounts), has personal liability for the misrepresentation. This excludes directors who can prove that they acted in good faith and with lack of knowledge.

Directors can also face liability under rule 13b2-2 of the Exchange Act 1934 if they:

- Make a materially false statement to an accountant in connection with an audit or the preparation of an SEC filing.
- Fraudulently influence, coerce, manipulate or mislead an accounting firm during an audit, with the intention of rendering the financial statements materially misleading.
- In addition, problems with company accounts can result in directors facing fiduciary duty claims for failing to exercise oversight (see *Question 18*).

39. Do a company's accounts have to be audited?

A public company's annual financial statements must be audited by a registered independent accounting firm. Interim financial statements are not audited (they are reviewed).

40. How are the company's auditors appointed? Is there a limit on the length of their appointment?

A public company's audit committee must be directly responsible for the appointment, compensation and oversight of the independent auditors (*section 301, Sarbanes-Oxley Act 2002*). The audit committee has authority to approve all audit engagement terms and fees, as well as the authority to terminate the engagement. Companies typically seek shareholder ratification of independent auditor appointments.

Lead audit partners must rotate every five years (*section 203, Sarbanes-Oxley Act 2002*). Audit firm rotation is not required.

41. Are there restrictions on who can be the company's auditors?

Any firm auditing a public company's financial statements must be registered with the Public Company Accounting Oversight Board (PCAOB). They must also meet independence requirements provided in the federal securities laws (such as rule 10A-2 of the Exchange Act 1934) and PCAOB rules (*rule 3520, PCAOB*).

42. Are there restrictions on non-audit work that auditors can do for the company that they audit accounts for?

Rule 2-01 of regulation S-X prohibits auditors from providing certain non-audit services to their clients and their client's affiliates, including:

- Bookkeeping and other services related to the accounting records or financial statements of the client.
- Financial information systems design and implementation.
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.
- Actuarial services.
- Internal audit outsourcing services.
- Management functions or human resources.
- Broker-dealer, investment adviser, or investment banking services.
- Legal services.
- Expert services unrelated to the audit.

The audit committee must also determine whether any service provided by the auditors can impair the firm's independence.

43. What is the potential liability of auditors to the company, its shareholders and third parties if the audited accounts are inaccurate? Can their liability be limited or excluded?

An auditor can be liable to the company for breach of contract, negligence or fraud, if the audited accounts are inaccurate.

Shareholders and other third parties can also have claims against the auditor for negligence or fraud.

The SEC can also bring proceedings to censure or temporarily or permanently bar auditors from appearing or practicing before the SEC if they are found to have engaged in improper professional conduct.

Auditor engagement letters can include a provision purporting to limit the auditor's liability and/or provide for indemnification under certain circumstances.

44. What is the role of the company secretary (or equivalent) in corporate governance?

Companies typically appoint a corporate secretary to:

- Organise and keep minutes of board, committee and shareholder meetings.
- Maintain corporate books and records.

- Manage company filings.

The corporate secretary is also a key advisor to the board and management on corporate governance matters. The corporate secretary can also be involved in engagement with shareholders and proxy advisory firms.

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