INSIGHTS

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SEC Amends Disclosure Requirements — **Page 3**

HILLARY HOLMES, BRIAN J. LANE, RONALD O. MUELLER, and **WILLIAM BALD** of Gibson, Dunn & Crutcher LLP discuss SEC amendments to Regulation S-K requirements, including description of business, legal proceedings, and risk factors.

Drafting Advance Notice Bylaws — **Page 13**

DOUGLAS K. SCHNELL, AMY SIMMERMAN, and **ZACK LENOX** of Wilson Sonsini Goodrich & Rosati examine several court decisions providing guidance on the proper drafting and use of advance notice bylaws.

Forum Selection Clauses Threatened — **Page 22**

PETER L. WELSH, ANNE JOHNSON PALMER, and **DANIEL E. FINE** of Ropes & Gray LLP explore a California court decision that may threaten reliance on forum selection clauses mandating litigation in the Delaware Court of Chancery.

DEPARTMENTS

26 IN THE COURTS

Protecting internal investigation materials...

29 STATE CORNER

Inspection rights governed by Delaware law...

31 CLIENT MEMOS

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SECURITIES DISCLOSURE

A Double-Edged Sword? Examining the SEC's Amendments to Regulation S-K Disclosure Requirements

The SEC has adopted amendments to several Regulation S-K requirements, including description of business, legal proceedings, and risk factors. They are designed to result in improved disclosure, tailored to reflect a registrant's particular circumstances, and reduce disclosure costs and burdens.

By Hillary Holmes, Ronald O. Mueller, Brian J. Lane, and William Bold

On August 26, 2020, as part of its continued effort to update and modernize public company disclosure requirements, the US Securities and Exchange Commission (SEC) adopted amendments to Item 101 (Description of Business), Item 103 (Legal Proceedings) and Item 105 (Risk Factors) of Regulation S-K at an open meeting of the SEC.[1] These amendments, which mark the first time that these disclosure requirements have been substantially updated in over 30 years, were designed to result in improved disclosure, tailored to reflect a registrant's particular circumstances, and reduce disclosure costs and burdens. Many of the amendments reflect the SEC's "long-standing commitment to a principles-based, registrant-specific approach to disclosure," which Commission Chairman Jay Clayton referred to at the open meeting as the "envy of the world."

In developing the proposed amendments, the SEC stated that it considered input from comment letters received in response to its disclosure modernization efforts, the SEC Staff's experience with Regulation S-K arising from the Division of Corporation Finance's disclosure review program, and changes in the regulatory and business landscape since the adoption of Regulation S-K. As a recent example, in response to the COVID-19 pandemic, the Division of Corporation Finance closely monitored registrants' disclosures about how COVID-19 affected their financial condition and results of operations. Division Staff observed that the current principles-based disclosure requirements generally elicited detailed discussions of the impact of COVID-19 on registrants' liquidity position, operational constraints, funding sources, supply chain and distribution challenges, the health and safety of workers and customers, and other registrant- and sector-specific matters. Chairman Clayton stated that

> [t]he effectiveness of this framework in providing the public with the information necessary to make informed investment decisions has proven its merit time and time again as markets have evolved when we have faced unanticipated events.[2]

However, this view was not shared by all of the Commissioners, as evidenced by the amendments' adoption by a 3-2 vote, with the two Democratic Commissioners dissenting.

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The Disclosure Amendments: A Principles-Based Approach

Description of Business (Item 101 of Regulation S-K)

The Description of Business disclosure generally appears only in the Annual Report on Form 10-K and in certain registration statements, including Form S-1 and Form 10. Currently, Item 101(a) requires a registrant to discuss the general development of its business during the last five years and states that a longer period may be addressed if material to an understanding of the business.[3] Item 101(c) further requires a registrant to address 12 specific topics if those topics are material to the registrant's business.[4] For example, if such disclosure would be material to its business, a registrant is required to disclose the practices of the registrant and its industry relating to working capital items.

The amendments to Item 101(a), which concerns the general development of the registrant's business, apply a more principles-based framework, eliminating the reference to a five-year timeframe and requiring disclosure of events that would be material to an understanding of the general development of the business. The amendments also allow registrants to provide only updates on material developments in the business or to the business strategy that have occurred since its most recent full discussion of the development of its business in a prior filing, with the prior disclosure incorporated by reference.

Item 101(c), which concerns a narrative description of the registrant's business, is similarly amended to use a principles-based approach and provide more flexibility. Instead of a set of 12 topics that "shall" be discussed if material, the amendments retain the general subject matter for disclosure ("the business done or intended to be done by the registrant," with a focus on each reportable segment), but set forth a non-exclusive list of seven topics that the disclosure "may include, but should not be limited to." Commissioner Elad L. Roisman stated his belief that the new approach would allow registrants to more clearly present information that they consider material in running their businesses.[5]

The non-exclusive list of disclosure topics includes some of the current 12 topics, but in many cases removes prescriptive or qualifying standards. For example, the amended language calls for a discussion of material government regulations, whereas the current rule specifically addresses only environmental regulations. We note that many registrants already include a discussion of material applicable government regulations despite the fact that the current rules do not explicitly require such disclosure. The amendments also add new topics, such as trends in market demand.

Of particular note is that the amended list of disclosure topics includes "[a] description of the registrant's human capital resources." This item received particular attention at the SEC meeting at which the rules were adopted and in the Commissioners' public statements. Chairman Clayton specifically lauded the inclusion of human capital as a disclosure topic, stating that

> [f]rom a modernization standpoint, today, human capital accounts for and drives long-term business value in many companies much more so than it did 30 years ago.[6]

The amendments do not include any specific human capital reporting framework or define "human capital." Instead, the amendments use a principles-based approach regarding the human capital-related resources, measures and objectives that a registrant focuses on in managing its business. The amendments stress the need for each registrant to consider how to make its disclosure specific to its industry and workforce approach and relevant to its unique facts and circumstances. Chairman Clayton stated that he expects "to see meaningful qualitative and quantitative disclosure, including, as appropriate, disclosure of metrics that companies actually use in managing their affairs" and that

> [a]s is the case with non-GAAP financial measures, [he] would also expect companies to maintain metric definitions constant from

> period to period or to disclose prominently any changes to the metrics used or the definitions of those metrics.[7]

Legal Proceedings (Item 103 of Regulation S-K)

Item 103 requires a registrant to disclose any material pending legal proceedings, other than ordinary routine litigation incidental to the registrant's business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject.[8] This requirement remains unchanged by the amendments. However, in an effort to eliminate duplicative disclosure,[9] the amendments expressly confirm that a registrant may provide the information required by Item 103 by hyperlink or cross-reference to a separate disclosure located elsewhere in the document.[10]

Currently, the instructions to Item 103 provide that governmental environmental proceedings that involve potential monetary sanctions of $100,000 or more must be disclosed. This quantitative threshold has resulted in disclosure of environmental proceedings that are immaterial to registrants. The amendments raise this threshold to require disclosure of environmental proceedings involving potential monetary sanctions of $300,000 or more, but allow a registrant to establish a different disclosure threshold as high as $1 million (or, if lower, one percent of the current assets of the registrant), provided that the registrant discloses that threshold in each of its annual and quarterly reports.

Risk Factors (Item 105 of Regulation S-K)

Currently, Item 105 requires disclosure of the most significant factors that make investing in the registrant speculative or risky.[11] Over time, the length of the Risk Factors section generally has increased, driven by developments in private securities litigation and the emergence of new areas and types of risk. Against this backdrop, the SEC stated its concern that, in many cases, generic and boilerplate risks that could apply to any registrant have contributed to the increased length of risk factors, limiting the helpfulness of the disclosure to investors.[12]

The amendments to Item 105 attempt to counter the current trend toward ever-expanding risk factor disclosures in three ways.

First, the amendments require all risk factors to be grouped and organized under relevant headings. Generic risk factors that could apply to any registrant or any offering are required to be disclosed at the end of the Risk Factors section under the heading "General Risk Factors."

Second, the amendments change the standard for risk factors by requiring disclosure of "material" factors, instead of "the most significant" factors that make an investment speculative or risky. Other wording changes emphasize that risk factors should "concisely" explain how each risk affects the registrant or its securities.

Third, if a registrant's Risk Factors section exceeds 15 pages, the amendments require inclusion of a summary risk factor section that is no more than two pages long. The summary must comprise

> concise, bulleted or numbered statements summarizing the principal factors that make an investment in the registrant or offering speculative or risky.

A summary risk factor section such as this already generally is included in the prospectus summary for registration statements.

Interestingly, Commissioner Hester M. Peirce said she views the risk factors amendment as a "bit of an experiment," asking whether the "penalty of having to prepare a summary [will] be sufficient to overcome the fear of litigation that pushes companies to disclose many pages of risks."[13]

Effective Date and Next Steps

The final rules as amended will be effective 30 days after publication in the *Federal Register*. As of the date of this article, the final rules had not been published.

As a result, the amendments may be in effect at the time registrants file their Form 10-Q for the third quarter of 2020. Accordingly, a registrant that

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voluntarily repeats its risk factors in each Form 10-Q may need to reorganize, caption, and revise its risk factors prior to filing the next Form 10-Q, or determine whether to only provide any material changes from risk factors that previously were disclosed in the registrant's Form 10-K or prior Form 10-Qs.[14]

The amendments will have a greater impact on the content of the Form 10-K for 2020. Registrants should expect to devote additional time to drafting and disclosure committee review of their next Form 10-K. The amendments also will impact the content of securities offering documents, including registration statements for IPOs and spin-offs and presumably private placement offering memorandum.

The Dissent Calls for a Different Approach

In their respective public statements,[15] Commissioner Allison Herren Lee and Commissioner Caroline Crenshaw pushed back on the enhanced, principles-based approach reflected in the new rules, voicing their dissent at the lack of specific disclosure requirements concerning Environmental, Social and Governance (ESG) matters. Specifically, the dissents focused on the absence of prescriptive rules requiring disclosures and metrics addressing diversity, climate change risk and human capital.

In response, Commissioner Peirce stated in a closing comment at the open meeting of the SEC that the dissent's approach was more prescriptive-based than principles-based and the changes the dissenters' advocated would require a more complete review of the entire disclosure framework. In an exchange between the two, Commissioner Lee did not completely decry the use of the principles-based approach, stating instead that a different approach was needed.

Human Capital

Despite the emphatic praise given to the inclusion of human capital as a disclosure topic under Item 101 by some members of the SEC, Commissioners Crenshaw and Lee expressed their view that the amendments do not contain adequate disclosure requirements regarding human capital. Commissioner Crenshaw suggested that, by requiring standardized disclosures around how a registrant manages and invests in its people, investors would be better able to assess how a registrant would perform in a crisis such as the COVID-19 pandemic. Commissioner Lee stated,

> I would have supported today's final rule if it had included even minimal expansion on the topic of human capital to include simple, commonly kept metrics such as part time vs. full time workers, workforce expenses, turnover, and diversity.

Climate Risk

Both dissenters also focused on the absence of disclosure requirements relating to climate change, including the risks created thereby. Commissioner Lee expressed the concern that the SEC "failed to include, or even discuss whether to include, the crucial topic of climate risk."[16] While acknowledging that the SEC has issued guidance related to the discussion of climate risks, both Commissioners cited investor comments as evidence that the current rules and guidance under the principles-based regime are inadequate.

Diversity

An additional point of focus for the two dissenters was the absence in the amendments of requirements for disclosure regarding diversity. In support of the contention that diversity may be material to an investment decision, Commissioner Lee noted that a recent study found that companies in the top quartile for ethnic diversity on executive teams outperformed those in the bottom quartile by 36 percent in profitability.

Perspectives and Recommendations

The amendments represent an important step towards modernizing the disclosure framework in the United States, removing detailed and prescriptive standards that are either duplicative of other

disclosure requirements or, for many registrants, simply not material. While the principles-based approach could lead to a lack of comparability for investors among registrants' reports, it also could fail to achieve the goal of providing more informative disclosures if the absence of technical guidance or requirements results in excessive disclosures. How the new framework is applied by registrants will evolve and develop over time and be shaped by guidance from the SEC and its Staff, the demands of the capital markets, and developments in securities litigation.

The increased regulatory reliance on principles-based standards could prove to be a double-edged sword.

The increased regulatory reliance on principles-based standards could prove to be a double-edged sword. On the one hand, registrants will have greater license to adapt their disclosures to reflect their particular business model and operations, which is increasingly important in an innovative and dynamic economy where many aspects of companies' operations defy simple classifications. Moreover, permitting registrants to omit disclosure of information when it is not material may reduce registrant compliance costs. While some commenters are concerned that the move away from prescriptive disclosure standards will allow registrants to avoid addressing some topics, advocates for principles-based standards view that concern as ignoring the pressures of the capital markets and investor demands, which are sophisticated and already lead registrants to address topics not specifically identified in the SEC's existing rules. As noted by the SEC, this has been borne out by many registrants' disclosures during the COVID-19 pandemic.

On the other hand, the SEC noted that a principles-based disclosure framework relying on registrants' determinations of the importance of information to investors could result in increased information asymmetries between registrants and investors if registrants misjudge what information is material. While it said that such asymmetries may increase the cost of capital, reduce capital formation, and hamper efficient allocation of capital across companies, the SEC viewed the risk as being reduced by mitigants such as corporate internal controls and the risk of antifraud litigation.

A principles-based system also may make it more difficult for a registrant to demonstrate its compliance with the SEC's rules, presenting the risk of questioning and second-guessing by SEC Staff in hindsight, either through the comment or enforcement processes, and by class action plaintiffs. While materiality has been and remains the overriding standard, the prescriptive list of topics contained in Item 101 prior to these amendments has served as a useful touchstone for registrants.

As registrants consider changes to their disclosure, it will be important for them to assess and potentially adjust their disclosure controls and procedures, including examining their processes for assessing materiality and documenting determinations regarding disclosures and ensuring that disclosure committees and others involved in their disclosure processes are mindful of the need to focus on the principles-based standards.

This principles-based set of requirements also could lead, over time, to inconsistent discretion on the part of the SEC Staff when determining whether registrants have complied with the requirements of Regulation S-K. This could increase the cost and length of a review process (whether routine or for a capital markets transaction, which have become increasingly streamlined in recent years), which is inconsistent with the SEC's stated policy position of lowering the burden of being a public company and promoting capital raising.

Notwithstanding the absence of prescriptive standards, we expect human capital disclosure to evolve, as it already has in the midst of the COVID-19 pandemic, and the demand from investors for disclosure about climate risk to continue. In an election year, it is worth noting that both dissenting Commissioners are Democrats. Thus, depending on the outcome of the elections in November, future developments

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in disclosure requirements could reflect the views expressed in their dissents.

In the meantime, one of the biggest open questions will be with respect to disclosure regarding a registrant's "human capital resources, including … any human capital measures or objectives that the registrant focuses on in managing the business." This question must be evaluated in a manner tailored to the specific registrant and its workforce. To protect against excessive and unnecessary detail, a company should bear in mind that the federal securities laws and the principles-based framework of

Detailed Description of the Amendments and Sample Recommendations

Regulation SK Item	Existing Item Requirements	New Item Requirements
Item 101(a)(1)	• Prescribed a five-year timeframe for disclosure of general developments of a registrant's business, but with exceptions. • Disclosure should include the year in which a registrant was formed.	• The five-year disclosure timeframe has been eliminated. • Disclosure may include, but is not limited to, the topics specifically addressed in the provision, subject to a materiality standard. • If material, disclosure should include any material changes to a previously disclosed business strategy. • Disclosures of the year and form of organization and any material changes to the mode of conducting business are no longer specifically required.
	Gibson Dunn Comment: Companies should be sure their disclosure covers information that is material to an understanding of the general development of their business, including any changes in strategy.	
Item 101(a)(2)	• No previous equivalent.	• A registrant can provide an update to the general development of its business by disclosing all of the material developments that have occurred since the most recent registration statement or report that includes a "full discussion" of the general development of its business and then hyperlinking or incorporating by reference the prior "full discussion."
	Gibson Dunn Comment: • This new provision may be of utility primarily for companies that do not frequently update their business development disclosures. For many companies that have relatively short disclosures or that frequently update their disclosures, the provision may not be too useful. • While an update can incorporate by reference a single prior disclosure, interpretive guidance may be needed on how this provision interacts with the "no double incorporation by reference" provisions of Securities Act Rule 411(e) and Exchange Act Rule 12b-23(e).	
Item 101(c)	• While focusing on disclosure regarding reportable segments, the provision sets forth a list of 12 disclosure topics that shall be addressed if material to the registrant's business taken as a whole.	• The amended rules continue to focus on disclosure of reportable segments, but calls generally for disclosure of information material to an understanding of the registrant's business as a whole, including but not limited to seven topics listed in the provision.

Regulation SK Item	Existing Item Requirements	New Item Requirements
Segment-Level Disclosure Requirements	• Disclosure topics from the current rule that have been significantly revised include the following:	• As revised, the disclosure topics address the following:
	— The principal products produced and services rendered by the segment, and the principal markets for, and methods of distribution of, the segment's principal products and services. — The amount or percentage of total revenue contributed by any class of similar products or services which accounted for 10 percent or 15 percent or more of consolidated revenue in any of the last three years. — The dependence of the segment upon a single customer, or a few customers, and in certain cases the name of any ≥10 percent customers.	— Revenue-generating activities, products and/or services, and any dependence on revenue-generating activities, key products, services, product families or customers, including governmental customers.
	— The status of a product or segment if there has been a public announcement of, or if the registrant otherwise has made public information about, a new product or segment that would require the investment of a material amount of the assets of the registrant or that otherwise is material. — Competitive conditions in the business including the markets in which the registrant competes, the number of competitors, the registrant's competitive position, and the principal methods of competition.	— The status of development efforts for new or enhanced products, trends in market demand and competitive conditions.
Segment-Level Disclosure Requirements	• Disclosure topics from the current rule that have been retained without significant revisions include the following:	• The disclosure topics now address the following:
	— The sources and availability of raw materials. — The importance to the segment and the duration and effect of all patents, trademarks, licenses, franchises and concessions held.	• All resources material to a registrant's business (including, for example, the sources and availability of raw materials and the importance to the segment and the duration and effect of all patents, trademarks, licenses, franchises and concessions held).
	— A description of any material portion of the business that may be subject to renegotiation of profits or termination of contracts or subcontracts at the election of the Government	• Same
	— The extent to which the business is or may be seasonal	• Same

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Regulation SK Item	Existing Item Requirements	New Item Requirements
Segment-Level Disclosure Requirements	• Disclosure topics from the current rule that have been eliminated include the following:	
	◦ The practices of the registrant and the industry relating to working capital items such as inventory requirements, rights to return merchandise, and providing extended payment terms. ◦ The dollar amount of backlog orders currently and in the preceding year, and the portion not reasonably expected to be filled in the current year.	
	Gibson Dunn Comment: Although the foregoing topics have been dropped as topics to be specifically addressed, companies should continue to evaluate whether these topics are material to an understanding of the registrant's business as a whole, and if so to continue addressing them.	
Company-Level Disclosure Requirements	• Disclosure topics from the current rule that have been significantly revised include the following:	• As revised, the disclosure topics address the following:
	— The material effects that compliance with laws that protect the environment may have on capital expenditures, earnings and competitive position, including any material estimated future capital expenditures for environmental control facilities. — The number of persons employed.	— The material effects that compliance with all government regulations (not just environmental regulations), may have on capital expenditures, earnings, and competitive position, including the estimates capital expenditures for environmental control facilities. — Human capital resources, the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel).
	Gibson Dunn Comment: • Many companies already include disclosure of the impact of material governmental regulations. Companies will need to consider whether regulatory issues are better addressed in the description of their business or in their risk factors, or whether specific regulatory matters should be addressed in both. • As addressed earlier in this client alert, companies should focus on any human capital resources, objectives or measures that are material to them as a whole.	
Item 103	• $100,000 threshold for disclosure of environmental proceedings involving monetary sanctions and in which the government is a party.	• Potential monetary sanctions threshold is raised to $300,000. • Alternatively, a registrant is allowed to set its own disclosure threshold, provided that the threshold cannot exceed the lesser of $1 million or 1% of current assets, and the registrant must disclose the threshold in each annual and current report. • Specifically provides that information about material legal proceedings can be provided by including hyperlinks or cross-references to legal proceedings disclosure located elsewhere in the document in order to avoid duplicative disclosure.

Regulation SK Item	Existing Item Requirements	New Item Requirements
	Gibson Dunn Comment: • Many companies already cross-reference or incorporate by reference disclosures that appear in their financial footnotes and/or MD&A. The new rules may lead companies to also include an internal hyperlink. • Interpretive guidance may be required to confirm whether disclosure of an alternative dollar threshold for environmental proceedings must be disclosed even when companies have no such proceedings to report, or only when a proceeding involves sanctions exceeding the $300,000 threshold. Disclosing the dollar amount of a company-determined materiality threshold is not currently a common practice.	
Item 105	• "Most significant" risk factors must be disclosed.	• Risk factors are required to be organized under relevant headings, with any risk factors that may generally apply to an investment in securities disclosed at the end of the risk factor section under the caption "General Risk Factors." • Only "material" factors are required to be disclosed. • If the Risk Factor section exceeds 15 pages, a maximum two page "summary risk factor disclosure" is required.
	Gibson Dunn Comment: • Companies should confirm that their risk factor subcaptions adequately describe the specific risks addressed, and that their risk factors "concisely explain" how each risk affects the company. • Many companies already include summaries of their risk factors in their forward-looking statement disclaimers or in the prospectus summary for registration statements. Companies involved in numerous, complex, or highly regulated businesses, as well as those that may be exposed to class action securities litigation, may determine that it is appropriate to include more than 15 pages of risk factors, notwithstanding the additional disclosures that will be triggered.	

the amendments continue to turn on the concept of materiality. In a sense, this exercise is similar to conducting a SAB 99 analysis of human capital factors to identify those that are truly material using the established legal standard (*i.e.,* that there is a substantial likelihood that a reasonable investor would view this as altering the total mix of information).

As a practical matter, management should begin by (1) reviewing their existing internal and external statements regarding key human capital resources, measures and objectives; (2) reviewing their past engagement with and input from shareholders on this topic; and (3) reviewing the list of disclosure topics suggested in the adopting release.[17] Management should be mindful that the disclosure should be focused on the resources, measures, and/or objectives that are used in managing the company *and* are material to an understanding of the business as a whole. Only certain information will rise to this level. Not every aspect of human capital management that the board or senior management monitors, or that the company already may voluntarily report in a sustainability or human capital report, necessarily rises to the level of being material enough to discuss in the Description of Business section of the Form 10-K. Moreover, the fact that certain investors may be focused on particular aspects of human capital does not mean that the information is material to investors seeking to understand the registrant's business as a whole.

As recognized by the SEC, there are a wide range of issues and degree of focus on human capital management at different companies and in different industries. Thus, we should expect the disclosures

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to vary widely among industries and companies, and to evolve over time.

Notes

1. *See* Modernization of Regulation S-K Items 101, 103, and 105, Exchange Act Release No. 33-10825 (August 26, 2020), available at *https://www.sec.gov/rules/final/2020/33-10825.pdf.*
2. Modernizing the Framework for Business, Legal Proceedings and Risk Factor Disclosures, available at *https://www.sec.gov/news/public-statement/clayton-regulation-s-k-2020-08-26.*
3. *See* 17 C.F.R. § 229.101(a).
4. *See* 17 C.F.R. § 229.101(c).
5. *See* Opening Remarks at the Open Commission Meeting to Adopt Amendments to Items 101, 103, and 105 of Regulation S-K, available at *https://www.sec.gov/news/public-statement/roisman-reg-sk-2020-08-26.*
6. *See supra* n.2.
7. *Id*.
8. *See* 17 C.F.R. § 229.103.
9. For more information about the SEC's efforts to streamline duplicative disclosures, please refer to our client alert available at *https://www.gibsondunn.com/wp-content/uploads/2018/08/sec-streamlines-disclosure-requirements-as-part-of-its-overall-disclosure-effectiveness-review.pdf.*
10. Exchange Act Rule 12b-23, Instruction G(1) of Form 10-K and Instruction D.2. to Form 10-Q already allowed for this type of cross-reference and incorporation by reference.
11. *See* 17 C.F.R. § 229.105.
12. *See supra* n.1 at 65-66.
13. Statement at Open Meeting on Modernization of Regulation S-K 101, 103, and 105, available at *https://www.sec.gov/news/public-statement/peirce-reg-s-k-2020-08-26*.
14. Item 1A to Form 10-Q only requires disclosure of material changes from those disclosed in a registrant's Form 10-K, and Exchange Act Rule 12b-23 and Instruction D.2. to Form 10-Q allow risk factors that were disclosed in prior 10-Qs to be incorporated by reference.
15. *See* Regulation S-K and ESG Disclosures: an Unsustainable Silence, available at *https://www.sec.gov/news/public-statement/lee-regulation-s-k-2020-08-26*; *see* Statement on the "Modernization" of Regulation S-K Items 101, 103, and 105, available at *https://www.sec.gov/news/public-statement/crenshaw-statement-modernization-regulation-s-k*.
16. Regulation S-K and ESG Disclosures: An Unsustainable Silence, available at *https://www.sec.gov/news/public-statement/lee-regulation-s-k-2020-08-26*.
17. The amended Item 101 provides the following examples, "depending on the nature of the registrant's business and workforce: measures or objectives that address the development, attraction and retention of personnel."

    The adopting release asked commenters whether the SEC should include other examples in the amendments and specifically mentioned the following possibilities:
    - number and types of employees, including the number of full-time, part-time, seasonal and temporary workers;
    - measures with respect to the stability of the workforce, such as voluntary and involuntary turnover rates;
    - measures regarding average hours of training per employee per year;
    - information regarding human capital trends, such as competitive conditions and internal rates of hiring and promotion;
    - measures regarding worker productivity; and
    - the progress that management has made with respect to any objectives it has set regarding its human capital resources.

    The adopting release also noted that the following human capital topics were suggested by commenters (many of whom are recurring shareholder proposal proponents) in response to the Staff's earlier concept release:
    - worker recruitment, employment practices, and hiring practices;
    - employee benefits and grievance mechanisms;
    - employee engagement' or investment in employee training;
    - workplace health and safety;
    - strategies and goals related to human capital management and legal or regulatory proceedings related to employee management;
    - whether employees are covered by collective bargaining agreements; and
    - employee compensation or incentive structures.

CORPORATE GOVERNANCE

The Importance, Function, and Interpretation of Advance Notice Bylaws

Advance notice bylaws bring structure and predictability to stockholder meetings and ensure that stockholders have an adequate opportunity to fully consider the topics on which they are being asked to vote. Several courts—in Delaware and elsewhere—recently have provided new guidance on the proper drafting and use of advance notice bylaws.

By Douglas K. Schnell, Amy Simmerman, and Zack Lenox

Advance notice bylaws are an important tool for ensuring orderly stockholder meetings. They require a stockholder seeking to bring business before a meeting (*e.g.*, the nomination of a director candidate or the introduction of a stockholder proposal) to provide "advance notice" of that business to the company. In that way, they alter the default rule under Delaware law, which is that stockholders may propose business from the floor of a stockholder meeting. They also serve a significant disclosure function because they provide: (1) the company, its board of directors and its management with necessary information about the director nominees or stockholder proposal; (2) the board of directors with an opportunity to consider, and make a recommendation to all stockholders about, that business; and (3) stockholders with time to understand and consider the business in advance of making their voting decision.

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Several courts—in Delaware and elsewhere—recently have provided new guidance on the proper drafting and use of advance notice bylaws. These decisions build on earlier cases and provide fresh reminders of the continuing importance of well-drafted advance notice bylaws.

Courts Uphold the Validity of Advance Notice Bylaws

Two recent cases illustrate the presumptive validity of advance notice bylaws: (1) *BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd.*; and (2) *Blue Lion Opportunity Master Fund, L.P. v. HomeStreet, Inc.*

In *BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd.*,[1] the Delaware Supreme Court enforced the deadlines and supplemental information requirements found in the advance notice bylaws of two closed-end funds. The bylaws at issue were similar to the bylaws of many publicly traded companies. The Supreme Court allowed the funds to disregard a stockholder's nomination of directors due to the failure by the dissident stockholder to provide a completed questionnaire by the deadline imposed by the bylaws. In so doing, the Supreme Court reversed the Delaware Court of Chancery, which had issued an injunction requiring the funds to permit voting on the stockholder's nominees.

The Supreme Court's decision arose out of a proxy contest by Saba Capital Master Fund, Ltd. (Saba) at two closed-end funds (BlackRock Funds) managed by an affiliate of BlackRock, Inc. The advance notice bylaws of the BlackRock Funds required Saba to include in its nomination notice enough "information to establish to the satisfaction of the Board of Directors that the Proposed Nominee[s] satisf[y]

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the director qualifications" found in the bylaws of the BlackRock Funds.[2] These bylaws further allowed the respective boards of directors to seek "necessary" and "reasonably requested" updates and supplements to determine that the nominees met the director qualifications.[3] The bylaws also provided that any supplemental information requested by the BlackRock Funds had to be provided within five business days after the request. Relying on this provision, the BlackRock Funds requested that Saba complete a version of their standard director and officer questionnaire that contained almost 100 questions and stretched over 47 pages.

Saba did not object to the form or timing of the questionnaire but failed to return it within five business days. After the BlackRock Funds rejected Saba's nominations for failure to comply with the bylaws, Saba sought preliminary injunctive relief. Saba argued: (1) that the deadline for providing the questionnaires had not passed because (a) the record date for the annual meeting had not occurred, and (b) there was no obligation to update or supplement the information provided about the nominees in Saba's nomination notice until after the record date; and (2) even if the questionnaire was properly issued, much of the content was irrelevant and the questions exceeded the scope of what the BlackRock Funds were permitted to request from nominating stockholders under the funds' advance notice bylaws.

On Saba's first argument, the Delaware Court of Chancery found that the procedure for issuing the questionnaire was unambiguous and that the BlackRock Funds had validly requested supplemental information. On Saba's second argument, the Court of Chancery found that not all of the questions in the questionnaire were relevant to determine the qualifications of the nominees. At minimum, "thirty questions ... were not tied to" director qualifications.[4] Because a significant portion of the questionnaire was not "reasonably requested" or "necessary" to determine whether Saba's nominees met the director qualification requirements of the BlackRock Funds, the Court of Chancery held that the BlackRock Funds had overstepped their authority in demanding strict compliance from Saba.[5]

On appeal, the Delaware Supreme Court reversed, holding that the BlackRock Funds could enforce their advance notice bylaws and exclude Saba's nominees. The court rested its holding on two conclusions: (1) that the bylaws were clear and unambiguous; and (2) that Saba did not return the supplemental questionnaire within the deadline established by the bylaws.

First, the Supreme Court affirmed the Court of Chancery's finding that the procedure for updates and supplements to proposed nominations was clear and unambiguous. The court noted that although ambiguous bylaws are interpreted in favor of the stockholder franchise, courts will enforce unambiguous requirements.

Stockholders ignore clear deadlines in advance notice bylaws at their own peril.

Second, the Supreme Court found that Saba had not complied with the requirement to return the requested supplemental information (in the form of the completed questionnaire) within five business days. The Supreme Court acknowledged that many aspects of the questionnaire were not tethered to the nominees' qualifications, but it observed that many other questions were directly tied to those qualifications. Relying on principles of contract interpretation, the court emphasized that Saba, a sophisticated stockholder, remained "silent" within the five-day period and did not raise the concerns identified by the Court of Chancery until much later and as litigation approached, thus creating the appearance of "after-the-fact excuses."[6]

The Supreme Court's decision provides important support for the notion that Delaware courts will promote the orderly conduct of stockholder meetings and elections by enforcing well-drafted advance notice bylaws. It also is a reminder that stockholders ignore clear deadlines in advance notice bylaws at their own peril. The Supreme Court expressed its

> reluctan[ce] to hold that it is acceptable to simply let pass a clear and unambiguous

> deadline contained in an advance-notice bylaw, particularly one that had been adopted on a "clear day."[7]

Going forward, it can be expected that stockholders will look to raise any objections to the requirements of advance notice bylaws—particularly around supplementing information already provided—as early as possible. Companies, in turn, are likely to be scrupulous in enforcing any deadlines in their advance notice bylaws.

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In *Blue Lion Opportunity Master Fund, L.P. v. HomeStreet, Inc.*,[8] plaintiff Blue Lion Opportunity Master Fund, L.P. (Blue Lion) attempted to nominate a competing slate of directors at HomeStreet, Inc. (HomeStreet). HomeStreet's board of directors rejected Blue Lion's nominations for failure to comply with various timing and disclosure requirements in HomeStreet's advance notice bylaw, including several failures to comply with detailed and technical disclosure requirements under the federal proxy rules (which requirements were included in HomeStreet's advance notice bylaw). Blue Lion maintained that its submission, which was more than 100 pages in length, substantially and materially complied with HomeStreet's advance notice bylaw and that HomeStreet's rejection was based on immaterial deficiencies.

Although HomeStreet was a Washington state corporation, both sides looked to Delaware law to support their respective arguments. Blue Lion sought to demonstrate the importance of the stockholder franchise and the longstanding application by Delaware courts of a form of enhanced scrutiny to actions taken by directors that attempt to thwart that franchise. In contrast, HomeStreet sought to establish that bylaws are presumptively valid and part of a binding contract that, if unambiguous, are to be construed as written. HomeStreet also argued that its advance notice bylaw was adopted on a "clear day" many years prior and not in response to a threat, or perceived threat, from Blue Lion or any other stockholder. Further, HomeStreet asserted that the circumstances were not such that it was impossible for Blue Lion to comply with the advance notice bylaw.

In a brief decision, a Washington state court found that HomeStreet's advance notice bylaw was valid, that Blue Lion had failed to properly comply with its requirements, and that HomeStreet's board of directors had acted within its business judgment in rejecting the nominations.

Advance Notice Bylaws Must Be Drafted Carefully

Two cases from 2008 provide lessons on the importance of careful drafting of advance notice bylaws: *JANA Master Fund, Ltd. v. CNET Networks, Inc.*; and *Levitt Corp. v. Office Depot, Inc.*

In *JANA Master Fund, Ltd. v. CNET Networks, Inc.*,[9] CNET Networks, Inc. (CNET) contended that a stockholder seeking to nominate director candidates did not comply with CNET's advance notice bylaw. CNET's bylaw was unusual and required that a stockholder must have held $1,000 worth of stock in CNET for a full year before it could "seek to transact other corporate business at the annual meeting."[10] It also provided that any business must be proposed at least 120 days prior to the one-year anniversary of the release of CNET's proxy statement for the preceding annual meeting.

The Delaware Court of Chancery determined that CNET's advance notice bylaw applied only to proposals that a stockholder sought to have included in CNET's proxy statement (*i.e.*, proposals pursuant to Rule 14a-8). Parsing the language of the bylaw, the court found that it essentially tracked the requirements of Rule 14a-8 and "grafted" onto the bylaws the requirements of that rule.[11] Because the dissident stockholder nominated a competing slate of directors and intended to use its own proxy statement,

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the court found that CNET's advance notice bylaw did not apply to those nominations. This case highlights the care with which a court is likely to interpret the words used in the bylaw—with a thumb on the scale in favor of the stockholder franchise where the bylaw is not clearly drafted. In addition, external references to federal securities rules and regulations should be reviewed carefully to ensure that they operate as intended.

In *Levitt Corp. v. Office Depot, Inc.*,[12] Office Depot, Inc. (Office Depot) argued that a stockholder, Levitt Corp. (Levitt), was precluded from nominating two directors to Office Depot's board of directors because Levitt failed to notify Office Depot of its intention to propose director nominees. According to Office Depot, this represented a violation of the advance notice bylaw requirement that "[f]or business to be properly brought … the stockholder must have given timely notice thereof in writing."[13] In deciding the matter, the Delaware Court of Chancery found an inconsistency between Office Depot's advance notice bylaw and its notice of meeting (which formed a part of Office Depot's proxy statement). Specifically, the bylaw stated that

> [t]o be properly brought before an annual meeting, business must be (i) specified in the notice of the meeting … (ii) otherwise properly brought before the meeting by or at the direction of the Board of Directors or (iii) otherwise properly brought before the meeting by a stockholder … who complied with the notice procedures.[14]

Office Depot's notice of meeting stated that the purpose of the annual meeting was to "elect [12] members of the Board of Directors."[15] In interpreting these two documents together, the court found that Office Depot had brought the business—the election of directors—before the annual meeting for purposes of clauses (i) and (ii) of the advance notice bylaw. As a result, Levitt was not obligated to provide any advance notice to Office Depot of its director nominees, and Office Depot could not reject them.[16] The court noted that "careful drafting" of the notice of meeting is important to avoid unexpected stockholder business.[17] Many advance notice bylaws now provide these bylaws are the "exclusive means" for a stockholder to make nominations or propose other business (subject to the existence of a proxy access bylaw where applicable).

Company Conduct Should Not Undermine the Bylaws

Even where a company has a sound advance notice bylaw in place, its conduct and disclosures can jeopardize the protections that the bylaw affords.

As described above, Saba had to include sufficient detail in its advance notice submission to "establish to the satisfaction of the Board of Directors that the Proposed Nominee[s] satisf[y] the director qualifications as set out in" the BlackRock Funds' bylaws.[18] If the boards could not determine whether Saba's nominees satisfied the director qualifications, then the bylaws allowed the boards to request "reasonably requested" and "necessary" updates and supplements.[19] The Delaware Supreme Court affirmed the Court of Chancery's finding that the BlackRock Funds had failed to comply with the information requirements of their own bylaws by asking overbroad questions. At trial, the BlackRock Funds could not defend the necessity of many of the questions they asked of Saba. In other scenarios, similar conduct by a company could conceivably disadvantage the company in the middle of a proxy contest. Companies must balance carefully their legitimate interest in full disclosure from stockholders seeking to bring business before a meeting against the possibility that the questions asked could be beyond the scope of what is permitted by their bylaws.

Bay Capital Finance, LLC v. Barnes & Noble Education, Inc.[20] highlights the critical interplay between advance notice bylaws and the company's corresponding disclosures. Bay Capital Financial, LLC (Bay Capital), a stockholder in Barnes & Noble Education, Inc. (BNE), gave notice to BNE, on the last possible day under BNE's advance notice bylaw, of its intention to nominate a slate of

directors. BNE subsequently rejected Bay Capital's nomination because, at the time that it submitted its notice, Bay Capital was only a *beneficial* owner of BNE stock and not, as required by the bylaw, a *record* holder.

In the ensuing litigation, Bay Capital argued that BNE should not be allowed to enforce the advance notice deadline in its bylaw because, according to Bay Capital, it relied on the summary of the bylaw requirements found in BNE's proxy statement. In particular, Bay Capital argued that the proxy statement: (1) did not mention the record holder requirement and, as a result, Bay Capital was unaware of this requirement; and (2) prescribed a different method of computing the advance notice deadline from that found in the bylaw, and that Bay Capital had relied on the proxy statement calculation.[21]

The Delaware Court of Chancery appeared initially receptive to Bay Capital's arguments and granted Bay Capital's motion to expedite before any discovery based on Bay Capital's assertion that it relied on the proxy statement. However, discovery "pulled at the plaintiff's verified allegations as if they were loose threads on a sweater, unraveling them line-by-line to reveal the naked truth."[22] The court found that Bay Capital was aware of BNE's advance notice bylaw, "blew the deadline" and "then made up excuses for doing so."[23] The court also concluded that the discrepancy in the proxy statement ultimately would not yield a different deadline. The court ruled in favor of BNE and allowed it to exclude Bay Capital's nominees.[24] Despite the favorable outcome for BNE, the court stated that BNE "has some issues with the proxy language, and … the company should not view this ruling as an endorsement of that language."[25]

Hill Int'l, Inc. v. Opportunity Partners L.P.[26] underscores the importance of careful disclosure of a meeting date where deadlines in an advance notice bylaw are tied to that disclosure. In interpreting the advance notice bylaw of Hill International (Hill), the Delaware Supreme Court upheld a decision by the Court of Chancery enjoining Hill's annual meeting until a stockholder had an opportunity to make an advance notice submission. Hill's advance notice bylaw required, as a default, that a stockholder propose business not less than 60 or more than 90 days before the date of *that year's* annual meeting. This default rule was modified "in the event that less than [70] days notice or prior public disclosure of the date of the annual meeting is given or made to stockholders" to give stockholders 10 days from that notice or disclosure for their advance notice submissions.[27] In its 2014 proxy statement, Hill stated that its 2015 annual meeting would be held "on or about June 10, 2015" and provided indicative deadlines for advance notice submissions based on that assumed date.[28] Hill did not make any further statements about the date of its 2015 annual meeting until it mailed its proxy materials, which were mailed less than 70 days prior to the 2015 annual meeting and in which Hill announced that the 2015 meeting would be held on June 9, 2015. On these facts, the Court of Chancery had to consider whether the 2014 proxy materials sufficiently disclosed the date of the 2015 annual meeting or whether there had been less than 70 days' notice of the date of the meeting. The Court of Chancery and the Delaware Supreme Court both sided with the stockholder, concluding that the advance notice bylaw unambiguously required notice of the specific "actual date" of the annual meeting, not just an "anticipated date."[29] Accordingly, the 2014 proxy statement was not sufficient public disclosure of the meeting date for the 2015 annual meeting and the stockholder was permitted to submit its advance notice.[30]

Advance Notice Bylaws and Changed Circumstances

Any discussion of advance notice bylaws would be incomplete without addressing the concept of "changed circumstances" and the related equities surrounding the enforcement of these bylaws. Under this doctrine, a court can, in certain circumstances, compel a company to waive its advance notice bylaw and permit a stockholder to nominate directors (and potentially propose business) after the advance notice deadline has passed.

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AB Value Partners, LP v. Kreisler Manufacturing Corp.[31] illustrates how Delaware courts analyze the interplay between changed circumstances and an advance notice bylaw. Plaintiff AB Value Partners (AB Value) sought to enjoin the enforcement of the advance notice bylaw of Kreisler Manufacturing Corp. (Kreisler) so that AB Value could nominate a competing slate of directors. AB Value's request was based in large part on the occurrence of two material events after the advance notice deadline. First, 37.2 percent of Kreisler's voting shares were distributed from a trust to the individual beneficiaries of the trust. AB Value argued that the distribution of the shares—from a bloc held by the trust to individuals—materially altered the likelihood of successfully electing a competing slate of directors. The Delaware Court of Chancery, noting that "[s]tockholder composition changes frequently in companies," found that the "Kreisler Board had nothing to do with the effective dissolution of the trust" and refused to grant equitable relief on this basis.[32] Second, the board approved a pay raise for certain directors from $175,000 to $275,000 per year. AB Value characterized the pay raise as "grossly" self-interested and presented evidence of a director calling for a more independent compensation process.[33] However, the court noted that "the Board unanimously approved the resolution increasing the annual compensation" and that "neither the operations of [Kreisler] nor its business direction have changed."[34] Accordingly, the court refused to grant equitable relief because the pay increase did not "constitute a radical shift in corporate direction."[35]

Although AB Value was unsuccessful in its effort to enjoin the enforcement of Kreisler's advance notice bylaw, the court articulated a framework for analyzing changed circumstances and the potential waiver of advance notice bylaws. Under this framework, the court first will look to whether the changed circumstances occurred after the advance notice deadline. Second, the court will examine whether the change was unanticipated and material. And third, the court will examine whether the change was caused by the company's board of directors. Only if all three prongs are met will equitable relief to enjoin enforcement be appropriate.

AB Value drew heavily on the analysis in *Hubbard v. Hollywood Park Realty Enterprises, Inc.*[36] In that case, R.D. Hubbard filed suit against Hollywood Park Realty Enterprises, Inc. (Hollywood Park) and its sister company when they refused his request to extend their respective advance notice deadlines in order to allow him to nominate director candidates. When both companies refused his request, Hubbard submitted his nominations prior to the deadlines and filed an action for a declaratory judgment that the advance notice bylaws were invalid. Shortly thereafter, Hubbard and Hollywood Park entered into a settlement agreement under which Hubbard joined the board in exchange for his agreement to drop his proxy contest. Under the settlement agreement, the Hollywood Park board also agreed not to waive the advance notice bylaw provisions to permit a stockholder to nominate an opposing slate at the upcoming annual meeting.

Once he joined the board, Hubbard quickly (and surprisingly) gained the support of a majority of the existing directors for the operational and management changes that he championed. The management slate—comprised of Hubbard and his now allies—was set to run uncontested at the upcoming annual meeting. The other directors who now constituted the minority—including Merv Griffin, Aaron Spelling, and John Forsythe—sought to nominate a competing slate based on a platform that Hollywood Park be sold. Since the nomination deadline already had passed, the minority directors asked for a waiver of the advance notice bylaw. After determining that a sale of the company would not be in the best interest of stockholders, the Hollywood Park board denied the waiver request.

The minority directors contended that the enforcement of the advance notice deadline would be inequitable because those directors had no reason to believe it would be necessary to run a dissident slate while the nomination window was open. Prior to the nomination deadline and the appointment of Hubbard, the minority directors believed that the

Hollywood Park board was united in its opposition to Hubbard and had no reason to believe that, after the deadline had passed, Hubbard would win over a majority of the existing directors or that the directors would contractually bind themselves not to waive the advance notice provision.

The Delaware Court of Chancery granted the minority's motion for preliminary injunction and stated:

> [T]his is a case where the [Hollywood Park] board itself took certain action, after the by-law nomination deadline had passed, that involved an unanticipated change of allegiance of a majority of its members. It was foreseeable that that shift in allegiance would result in potentially significant changes in the corporation's management personnel and operational changes in its business policy and direction. Such material, post-deadline changes also would foreseeably generate controversy and shareholder opposition. Under those circumstances, considerations of fairness and the fundamental importance of the shareholder franchise dictated that the shareholders be afforded a fair opportunity to nominate an opposing slate, thus imposing upon the board the duty to waive the advance notice requirement of the by-law.[37]

In *Icahn Partners LP v. Amylin Pharmaceuticals, Inc.*,[38] the Delaware Court of Chancery found, on a motion to expedite, that a stockholder had stated a colorable claim for equitable relief. In that case, Carl Icahn, a substantial stockholder of Amylin Pharmaceuticals, Inc. (Amylin), alleged that Amylin's board of directors radically altered its outlook on the company after the advance notice deadline. The court found that before the advance notice deadline, both stockholders and the board understood that "a key element of the investment thesis for Amylin was the prospect for a value maximizing transaction."[39] However, after the deadline passed, the Amylin board rejected an offer to buy the company at a substantial premium. Icahn sought a waiver of the advance notice deadline in order to nominate director candidates. According to the court, if Icahn

> can show that … a key element of the investment thesis for Amylin was the prospect of a sale transaction, and that the Board has now abandoned interest in a sale transaction, … then Amylin's stockholders, including [Icahn], will be denied the opportunity to exercise their voting rights at an arguably critical time.[40]

The court granted Icahn's motion to expedite. Amylin was sold to Bristol-Myers Squibb Company shortly thereafter.

In 2018, in *In re Xerox Corporation Consolidated Shareholder Litigation*,[41] a New York Supreme Court enjoined Xerox Corporation (Xerox) from enforcing its advance notice bylaw. A stockholder had attempted to nominate directors after Xerox's advance notice deadline and after concerns arose over the process surrounding Xerox's planned sale to Fujifilm Holdings Corporation. The court quoted *Hubbard* and cited *Amylin* for the proposition that companies must waive their advance notice deadline where, among other things, a material change in circumstances that may "foreseeably generate controversy and shareholder opposition" occurs after the nomination deadline has passed.[42]

Takeaways and Drafting Tips

Companies should keep the following concepts in mind when thinking about their advance notice bylaw.

First, adoption of an advance notice bylaw or material changes to an existing bylaw should be undertaken, if at all possible, on a "clear day." Courts consistently have noted with approval when a company's decision to adopt an advance notice bylaw occurred well before a stockholder attempted to nominate directors or submit other business. Companies that install

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robust advance notice procedures without an imminent threat of stockholder action are laying the foundation for a fair and informative meeting at which all stockholders can engage. In contrast, boards that raise advance notice hurdles (including through material amendments to existing advance notice bylaws) in response to the receipt, or threatened receipt, of stockholder business may be viewed as attempting to entrench the sitting directors and tamper with the stockholder franchise. For similar reasons, companies also may wish to prepare any questionnaires contemplated by their advance notice bylaw on a clear day so as not to be accused of developing an onerous questionnaire only after a proxy contest has arisen.

Second, as with bylaws more generally, companies should make sure that the advance notice bylaw is reviewed regularly and updated to reflect the latest "technology" and activist stockholder tactics. For example, it is increasingly common—and an evolving best practice—for advance notice bylaws to require the submission of a version of the company's standard director and officer questionnaire with any director nomination or other stockholder proposal. Because this questionnaire must be requested from the company, it can provide an important early warning that a dissident stockholder may seek to conduct business at the annual meeting. Another example is that, over a decade after *CNET*, many advance notice bylaws still do not clearly distinguish their requirements from the requirements under Rule 14a-8 for the inclusion of stockholder proposals in the company's proxy statement. A third and final example is that advance notice bylaws should require explicitly the disclosure of any compensation, monetary or similar agreements, or voting commitments, between a stockholder and its director nominees.

Third, companies should ensure that their advance notice bylaw is sufficiently flexible to permit the board to gather appropriate information from the dissident stockholder and its nominees. Words such as "necessary" may limit the scope of questions that a company can ask of a stockholder, even if the requested information is, in the board's judgment, material to the board's ability to make recommendations to stockholders. At a minimum, the advance notice bylaw should require a nominating stockholder to provide: (1) all information about the candidate or stockholder proposal that would be required to be included in a proxy statement in a contested election; (2) information about any material relationships between the stockholder and the nominee; and (3) information about the candidate's independence and qualifications. Additionally, the advance notice bylaw should empower the board to solicit any other information that is reasonably foreseeable to be material to a stockholder's decision about the nominees or the stockholder proposal. Reasonable deadlines that are explicitly established in the bylaw for the receipt of this information are presumptively valid and likely to be enforced by a Delaware court.

Fourth, summaries of the terms and operation of the advance notice bylaw in any disclosure document must be accurate. This is particularly true of the calculation of any deadlines. Both *Bay Capital* and *Hill* highlight the risk that stockholders may attempt to rely on disclosures outside of a company's advance notice bylaw. For some additional potential protection, companies may wish to state in any disclosures that any discrepancy between the bylaw and the disclosure document must be resolved by reference to, and in favor of, the advance notice bylaw.

Fifth, companies should be mindful that substantial changes in board-level strategy after the advance notice deadline have the potential to result in a court determining that the advance notice window should be reopened.

Conclusion

Advance notice bylaws continue to be an important tool for every public company, and may be appropriate for some private companies. They bring structure and predictability to stockholder meetings and ensure that stockholders have an adequate opportunity to fully consider the topics on which they are being asked to vote. At the same time, they must be reviewed periodically to ensure that they continue to provide the intended benefits.

Notes

1. BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd., 224 A.3d 964 (Del. Jan. 13, 2020).
2. *Id.* at 968.
3. *Id.*
4. Saba Capital Master Fund, Ltd. v. BlackRock Credit Allocation Income Trust, 2019 Del. Ch. LEXIS 243, *15 (Del. Ch. June 27, 2019).
5. *Id.* at *19.
6. *Saba Capital* at 979.
7. *Id.* at 980.
8. Blue Lion Opportunity Master Fund, L.P. v. HomeStreet, Inc., Order Den. Mot. for Prelim. Inj., Case No. 18-2-06791-0 SEA (Wash. Super. Ct. Apr. 3, 2018).
9. JANA Master Fund, Ltd. v. CNET Networks, Inc., 954 A.2d 335 (Del. Ch. Mar. 13, 2008), *aff'd*, 947 A.2d 1120 (Del. May 13, 2008).
10. *Id.* at 337–338. The court did not reach the question of whether this stockholding requirement was an unreasonable restriction of stockholder rights.
11. *Id.* at 345.
12. Levitt Corp. v. Office Depot, Inc., 2008 Del. Ch. LEXIS 47 (Del. Ch. April 14, 2008).
13. *Id.* at *5.
14. *Id.* at *4–5.
15. *Id.* at *3.
16. Following this decision, many companies updated their notice of annual meeting to provide that the purpose of the meeting was to elect the directors *named in the company's proxy statement*.
17. *Id.* at *25 n.43.
18. *Saba Capital* at 968.
19. *Id.*
20. Bay Capital Finance, LLC v. Barnes & Noble Education, Inc., 2020 Del. Ch. LEXIS 113 (Del. Ch. Mar. 30, 2020).
21. Specifically, the bylaw required notice "not less than 90 days nor more than 120 days prior to the first anniversary of the date of the immediately preceding annual meeting," while the proxy statement (incorrectly) stated that notice was required not less than 90 days nor more than 120 days prior to the *forthcoming* annual meeting. *Id.* at *8–12.
22. *Id.* at *2.
23. *Id.* at *17 n.78.
24. *Id.* at *25. *See also* Openwave Systems Inc. v. Harbinger Capital Partners Master Fund I, Ltd., 924 A.2d 228 (Del. Ch. May 18, 2007) (permitting the corporation to enforce advance notice bylaw to bar untimely director nominations, notwithstanding litigation-driven arguments that the deadline was "confusing"); Accipiter Life Sci. Fund, L.P. v. Helfer, 905 A.2d 115 (Del. Ch. Aug. 2, 2006) (enforcing advance notice bylaw and rejecting arguments by a sophisticated stockholder that the company had acted inequitably by announcing the annual meeting date in an "obscure" manner in a 34-page press release).
25. *Bay Capital*, C.A. No. 2019-0539-KSJM, trans. ruling at *28 (Del. Ch. Aug. 14, 2019).
26. Hill Int'l, Inc. v. Opportunity Partners L.P.,119 A.3d 30 (Del. July 2, 2015).
27. *Id.* at 33–4.
28. *Id.* at 34.
29. *Id.* at 38–40.
30. More broadly, an important lesson of *Hill* is that it may be desirable to key advance notice deadlines to the date of the *prior year*'s annual meeting, not the date of the *current year's* meeting.
31. AB Value Partners, LP v. Kreisler Manufacturing Corp., 2014 Del. Ch. LEXIS 264 (Del. Ch. Dec. 16, 2014).
32. *Id.* at *16–7.
33. *Id.* at *17.
34. *Id.* at *18.
35. *Id.*
36. *AB Value* drew heavily on the analysis in Hubbard v. Hollywood Park Realty Enterprises, Inc., 1991 Del. Ch. LEXIS 9 (Del. Ch. Jan. 14, 1991).
37. *Id.* at *39–40. *See also* Health Corp Mgmt., L.P. v. Allscripts Healthcare Solutions, Inc., C.A. No. 7557-CS (Del. Ch. May 25, 2012) (order).
38. Icahn Partners LP v. Amylin Pharmaceuticals, Inc., 2012 Del. Ch. LEXIS 85 (Del. Ch. Apr. 20, 2012).
39. *Id.* at *4.
40. *Id.* at *10–11.
41. In re Xerox Corporation Consolidated Shareholder Litigation, 61 Misc. 3d 176 (N.Y. Sup. Ct. Apr. 27, 2018), *rev'd on other grounds sub nom.* Deason v. Fujifilm Holdings Corp., 165 A.D.3d 501 (N.Y. App. Div. Oct. 16, 2018).
42. *Id.* at 196.

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CORPORATE LITIGATION

California Court Refuses to Enforce Forum Selection Clause Requiring Litigation in Delaware

A recent decision from a California court may threaten reliance on forum selection clauses mandating litigation in the Delaware Court of Chancery. The California court found that the clause was not enforceable because the Court of Chancery does not provide for civil jury trials. Contracting parties will want to take notice and consider adapting going forward.

By Peter L. Welsh, Anne Johnson Palmer, and Daniel E. Fine

Delaware entities increasingly have relied on forum selection clauses mandating litigation in the Delaware Court of Chancery, in recognition of the Court of Chancery's expertise and consistency in its application of corporate law. A recent decision from a California state trial court, however, may threaten that reliance. On July 29, 2020, a judge of the California Superior Court ruled in *West v. Access Control Related Enterprises, LLC*[1] that a forum selection clause mandating litigation in Delaware was unenforceable in California because the site of the expected litigation in Delaware—the Court of Chancery—did not provide for civil jury trials. The court held that the enforcement of the forum selection clause in question would have abridged the right to a civil jury trial under California law. While the decision evidently does not apply to "equitable causes of action"[2] or derivative claims—many of the actions that currently are litigated in the Court of Chancery—the decision evidently applies to many other types of disputes. It also creates considerable uncertainty over whether specific types of claims are subject to its holding and therefore whether contract parties can reliably choose the Court of Chancery as their forum of choice. Further, the decision may spur other courts to push back on the frequent enforcement of such forum selection clauses, especially where enforcement of those clauses may implicate the interests of other states.

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Case Synopsis

The plaintiff, William West, brought suit against his former employer for wrongful termination, conversion, breach of fiduciary duty, and declaratory relief.[3] Based on a forum selection clause in the governing agreement mandating litigation in Delaware courts, the California Superior Court stayed the action.[4] The plaintiff then filed suit in Delaware and motion practice around jurisdiction and venue issues in Delaware ensued.[5] The Delaware Superior Court granted a motion to transfer the action to the Delaware Court of Chancery and held that the defendant's motion to strike the jury trial demand was moot, because the Court of Chancery does not conduct jury trials.[6] After that ruling, the plaintiff moved to lift the stay in California Superior Court on the ground that litigation in the Court of Chancery would deprive him of his constitutional right to a jury trial under California law.[7]

The California court lifted the stay and refused to enforce the forum selection clause, finding that its enforcement impermissibly would effect a pre-dispute waiver of the right to a jury trial under California law. The court reviewed precedent which has held that forum selection clauses that potentially impinge on "unwaivable rights created by California statutes" are presumed to be unenforceable.[8] The court noted that the right to a jury trial could only be waived under California law in a small number

of specific circumstances (*i.e.*, failure to appear at trial, failure to demand a jury trial, failure to pay the required fees, and consent after the beginning of the litigation). The court also relied on a recent California appeals court decision, *Handoush v. Lease Finance Group, LLC,* which held that a forum selection clause that included a pre-dispute jury waiver was unenforceable.[9] Extending *Handoush*, the court found—after observing that the Delaware Court of Chancery "simply does not conduct jury trials"[10]—that the forum selection clause before it impermissibly effected a waiver of the plaintiff's jury trial rights. Because the Court of Chancery did not conduct jury trials, as "a matter of fair process under the California Constitution," the court refused to enforce the forum selection clause at issue.[11]

Implications of the Decision

Delaware entities have relied increasingly on forum selection clauses in merger agreements, securities purchase agreements, financing agreements, joint venture agreements and other similar contracts—and even in their bylaws and certificates of incorporation—to ensure that litigation over key agreements and internal corporate matters is heard in the Delaware Court of Chancery. It is unsurprising that Delaware entities, and other sophisticated parties, would prefer the Court of Chancery for complex transactional litigation. That court is widely known as expert in corporate law. In fact, even the court in *Access Control* recognized that the "Chancery Courts are on the cutting-edge of corporate law."[12] In addition, by having their disputes settled in one court, Delaware entities can take comfort in being able to operate under a consistently-applied body of law. Delaware courts too have recognized these benefits for Delaware entities, and regularly enforce forum selection clauses.[13]

For these reasons, it is noteworthy when a court in another jurisdiction, particularly a populous jurisdiction with a large local economy like California, calls into question the broad enforceability of such forum selection clauses. For example, as in *Access Control*, defendants may now need to litigate claims for which a jury trial is available, such as employment-related or contract-based claims, in California courts to the extent that plaintiffs bring those claims in California. In addition, the decision provides a potential roadmap for other courts, who may or may not be supportive of the proliferation of Delaware-specific forum selection clauses and the potential impingement on home state interests, to limit the proliferation of these forum selection clauses in other circumstances and other jurisdictions. Further, the decision does not appear to draw a distinction between natural person and entity plaintiffs, or unsophisticated *pro se* parties and sophisticated parties represented by counsel. Therefore, the decision potentially could have broad applicability.

Litigation over the Existence of the Jury Trial Right

In view of the court's holding in *Access Control* that California's jury trial right will supersede a forum selection clause mandating litigation in the Delaware Court of Chancery, the most likely litigation issue relating to those forum selection clauses will be whether the right exists under California law for particular claims. To the extent that the jury trial right applies, then *Handoush* and *Access Control* could prevent the enforcement of such a Delaware Court of Chancery forum selection clause.

Under California law, there is no right to a jury trial for actions at equity[14] and for stockholder derivative actions.[15] This fact likely limits the potential application of the *Access Control* decision. Because California does not provide the right to a jury trial in actions at equity or derivative actions, California courts should respect a Delaware Court of Chancery forum selection clause in some of the more common disputes in corporate and deal litigation, such as suits for injunctive relief, specific performance, and shareholder derivative actions. In addition, claims for breach of fiduciary duty against corporate directors, officers or controlling stockholders, even for damages, generally are considered claims at equity

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under California law.[16] Thus, California courts likely will respect a Delaware Court of Chancery forum selection clause for claims for breach of fiduciary duty—perhaps the cause of action in corporate and transactional disputes most commonly in front of the Delaware Court of Chancery.

However, the Delaware Court of Chancery, while known as "Delaware's Constitutional court of equity,"[17] has jurisdiction in cases beyond equity—specifically, the Delaware Court of Chancery has subject matter jurisdiction over other claims as conferred by statute, even if those claims are not equitable in nature.[18] For example, claims to interpret a certificate of incorporation, corporate bylaws, a stock purchase agreement, a partnership agreement, a limited liability company agreement, or a merger agreement can be heard in the Delaware Court of Chancery.[19] This potentially large set of actions over which the Delaware Court of Chancery has jurisdiction could well be affected by the *Access Control* decision, and litigation may ensue as to whether, in the view of a California court and under California law,[20] these claims are actions at equity or law.

Arbitration could be used as a back-up forum.

Whether a claim is one in equity or at law under California law is a complex analysis looking at "the nature of the rights involved and the facts of the particular case" rather than the "form of the action."[21] Even if a claim is for damages, if the "gist" of an action relies on equitable principles, a California court nevertheless may consider the claim to be one in equity, rather than at law.[22] However these potential issues eventually are resolved, at this time, the *Access Control* decision leaves to a California court's determination the complex issue of whether a Delaware Court of Chancery forum selection clause is unenforceable due to the impingement of the jury trial right. It therefore threatens the certainty Delaware entities, and other commercial parties, previously enjoyed that many their disputes would predictably be heard in the Court of Chancery.

How Delaware Entities Can Respond

Access Control, in applying *Handoush*, makes clear that California courts will not enforce pre-dispute jury waivers of any kind, except for those allowed by statute (as described above, the failure to appear at trial, failure to demand a jury trial, failure to pay the required fees, and consent after the beginning of the litigation). Because of the frequent use of jury trial waivers in merger, securities purchase, or other agreements under Delaware law, Delaware entities will want to take notice of *Access Control* and the likelihood that any such jury trial waivers may not be enforced in California.

In response, Delaware entities, to the extent that they operate or have shareholders based in California, may consider relying on forum selection clauses that mandate litigation in the Delaware Court of Chancery, but have as a fallback a clause that requires a separate form of dispute resolution. As one option, those fallback clauses, after selecting the Court of Chancery as the presumptive primary forum, could include as a forum a court of law, such as the Delaware Superior Court or the US District Court for the District of Delaware, to the extent the latter has subject matter jurisdiction. Because jury trials are available in those jurisdictions, including these courts as fallback forums would work to preserve the civil jury trial right so as not to run afoul of *Handoush* or *Access Control*.

Alternatively, arbitration could be used as a back-up forum. As *Access Control* noted, and citing the California Supreme Court in *Grafton Partners v. Superior Court*,[23] pre-dispute arbitration agreements are enforceable, because they are subject to a different and broader statutory scheme than that related to civil jury trial waivers.[24] For that reason, to avoid a jury trial entirely, a Delaware entity might consider a forum selection clause mandating

the Delaware Court of Chancery, with an agreement to take any litigation to arbitration should the Delaware Court of Chancery become an unavailable forum.

Conclusion

It remains to be seen how parties to complex commercial transactions and other contracting parties will respond to the recent developments in California concerning the enforceability of forum selection clauses and jury waivers, but *Access Control* certainly raises substantial questions around such provisions that contracting parties will want to take notice and consider adapting to going forward.

Notes

1. West v. Access Control Related Enterprises, LLC, BC642062 (Cal. Super. Ct. 2016).
2. Nationwide Biweekly Admin., Inc. v. Superior Court of Alameda Cty, 9 Cal. 5th 279, 317 (2020).
3. *Access Control*, BC642062, at *2.
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.* at *3 (quoting Verdugo v. Alliantgroup, L.*P.*, 237 Cal. App. 4th 141, 147 (2015)).
9. Handoush v. Lease Finance Group, LLC, 41 Cal. App. 5th 729 (2019).
10. *Access Control*, BC642062, at *5.
11. *Id.* at *8 (emphasis omitted).
12. *Id.* at *7-8.
13. *See, e.g.*, Nat'l Indus. Grp. (Hldg.) v. Carlyle Inv. Mgmt., L.L.C., 67 A.3d 373, 381 (Del. 2013).
14. C&K Eng'g Contractors v. Amber Steel Co., Inc., 23 Cal.3d 1, 9 (1978).
15. Caira v. Offner, 126 Cal. App. 4th 12, 39 (2005).
16. Central Laborers' Pension Fund v. McAfee, Inc., 17 Cal. App. 5th 292, 347 (2017); Interactive Multimedia Artists, Inc. v. Superior Court, 62 Cal. App. 4th 1546, 1556 (1998) (no jury trial right because "entire fairness" test was based on equitable principles, so was not a claim at law).
17. Candlewood Timber Grp., LLC v. Pan Am. Energy, LLC, 859 A.2d 989, 997 (Del. 2004).
18. *Id.*
19. 8 Del. C. § 111.
20. As to whether the jury trial right applies to a specific action, whether the action is a claim in equity rather than at law is be determined by California, rather than Delaware (or any other state's) law. *See McAfee*, 17 Cal. App. 5th at 346.
21. *Nationwide Biweekly*, 9 Cal. 5th at 315 (quoting People v. One 1941 Chevrolet Coupe, 37 Cal. 2d 283, 299 (1951)).
22. *Id.* at 318 (citations omitted).
23. Grafton Partners v. Superior Court, 36 Cal. 4th 944, 959 (2005).
24. *Access Control*, BC642062, at *4.

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IN THE COURTS

Protecting Internal Investigation Materials From Disclosure

By Angela R. Jones and Zachary Chalett

In *United States ex rel. Wollman v. Massachusetts Gen. Hosp., Inc.*,[1] yet another district court agreed with the US Court of Appeals for the District of Columbia Circuit's decision in *In re Kellogg Brown & Root, Inc.*[2] holding that, although the defendants waived it here, attorney-client privilege applies to internal investigations. While the district court's decision should provide comfort to white collar and corporate compliance attorneys, it also should serve as a warning regarding the importance of following best practices for protecting privilege and the, often, limited application of the work product doctrine in the context of internal investigations.

Easy to Recite, Often Hard to Apply

The elements of the attorney-client privilege, "while easy to recite, are often hard to apply."[3] As a reminder, attorney-client privilege applies so long as these basic elements are met: (1) a communication; (2) made between privileged persons; (3) in confidence; (4) for the purpose of seeking, obtaining, or providing legal assistance to the client.

Under the US Supreme Court's decision in *Upjohn Co. v. United States*[4] and, more recently, the DC Circuit's decision in *In re Kellogg Brown & Root, Inc.*, the attorney-client privilege should apply to internal investigations.[5] In *Kellogg*, the plaintiff/relator brought a claim against a defense contractor for allegedly defrauding the federal government. In vacating the district court's order finding that the contractor must produce internal investigation materials related to the subject matter of the complaint, the circuit court held that the contractor's prior internal investigation into the alleged fraud was protected because a primary purpose of the investigation was to provide or obtain legal advice.

Absent an exception, disclosing attorney-client communications to a third party waives the privilege. Exceptions are narrowly construed. For example, the *Kovel* doctrine provides an exception for third parties employed to assist an attorney in providing legal advice (*e.g.*, accountants and financial advisors), but the third party's involvement must be highly useful for effective representation and "the communication must be made for the purpose of obtaining legal advice from the lawyer."[6]

The work product doctrine applies more narrowly than attorney-client privilege in that it applies only in the litigation context, but it does not require the provision of legal advice. In short, the work product doctrine shields from discovery "documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative. . . ."[7] Disclosing a document protected by the work product doctrine to a friendly third party generally does not waive the protection, unless the disclosure materially increases the opportunity of subsequent disclosure to a litigation adversary. However, unlike the attorney-client privilege, the work product protection from disclosure is not absolute even without waiver.

Application of Privilege

In *Wollman*, the plaintiff/relator brought a *qui tam* action under the federal False Claims Act (FCA) alleging that the defendants fraudulently billed Medicare and Medicaid for overlapping and concurrent surgeries. *Qui tam*, which translates to "in the name of the king," allows persons with evidence of fraud against

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the federal government to sue the alleged wrongdoer on behalf of the government pursuant to the FCA. As part of the action here, the plaintiff sought to compel the defendants to produce a report issued by an attorney (Stern) as part of an internal investigation conducted in response to earlier criticisms made by a surgeon employed by one of the defendants (Massachusetts General Hospital or MGH) regarding the practice of overlapping surgeries. The plaintiff contended that the report was not privileged because Stern was hired to conduct a fact investigation and not to provide legal advice. The plaintiff further asserted that even if the report was privileged, the defendants waived privilege (1) when they provided the report to a public relations firm (Rasky) to help respond to an investigation by *The Boston Globe* into overlapping surgeries, and (2) by sending a copy of the report to MGH's chair of the board at her email address for Simmons University, where counsel for the university found it in connection with responding to a subpoena in a separate matter. As part of the proceeding, the court conducted an *in camera* review of the report and associated documents, including interview memoranda prepared during the investigation.

The court held that the report and related documents were not protected by the work product doctrine because defendants failed to show that the report was prepared in anticipation of litigation or for use in litigation. The court noted that the work product doctrine does not apply simply because "the *subject matter* of a document relates to a subject that might conceivably be litigated."[8] That a company may be concerned that a party "might bring litigation sometime in the future is not sufficient to qualify for attorney work product protection."[9]

In contrast, the court held that the attorney-client privilege applied to the report. It did so principally for four reasons. First, the engagement letter stated that Stern would be providing "legal representation." The letter also implied that Stern would be working with in-house counsel and was hired to address legal issues in connection with the investigation. Second, the report was labeled "Confidential Attorney Client Privileged Communication" and related to concerns regarding potential violations of billing regulations and exposure to legal liability. Third, the client interviews conducted in connection with the report focused on areas that raised issues of potential liability and the associated memoranda were labeled as privileged and confidential. Fourth, the deposition transcripts prepared in discovery indicated that those involved with the decision to hire Stern did so with the understanding that counsel would be investigating claims of legal violations.

Although the court held that attorney-client privilege applied to the report, it determined that MGH had, in part, waived privilege based on its production of the report to its public relations firm, Rasky. The court found that the *Kovel* doctrine did not apply because Rasky did not assist in consultations between MGH and its attorney and its involvement did not relate to obtaining legal advice. Rasky was retained to provide advice in the context of *The Boston Globe*'s reporting on overlapping surgeries, which occurred three to four years after Stern conducted his investigation. The court also rejected the defendants' argument that because Rasky served as the "functional equivalent" of an employee, the privilege extended to Rasky. The court determined that Rasky was a consultant rather than an agent of the defendants because it was hired only for specific projects, worked out of its own offices, and worked for other clients.

As to the scope of the waiver, the court concluded that it should be limited to the report, any materials provided to Rasky, and any communications with Rasky regarding the report. It is well settled that waivers can, by implication, extend beyond the matter revealed. But the court did not find subject-matter waiver here because the defendants did not use the extrajudicial disclosure of the report to gain an advantage against the opposing party.

Lastly, the court held that the alleged disclosure of the report to counsel for Simmons University (via disclosure of the report to the board chair using her Simmons University email address) did not constitute waiver because it was unclear whether counsel reviewed the report and absent such review, there was no actual disclosure of privileged information to a third party. But, even if counsel had reviewed the report, the court determined that such disclosure would not waive privilege because the

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email attaching the report and the report itself were marked as privileged and there was no evidence that counsel disseminated the report.

Key Takeaways

To avoid the problems faced by defendants in *Wollman* and protect privilege in internal investigations, attorneys conducting internal investigations—and companies engaging such attorneys—should consider these key takeaways:

- Ensure attorney involvement in and oversight of the internal investigation.
- Do not expect the work product doctrine to shield internal investigation materials from disclosure as a matter of course; reasonable anticipation of litigation is required. If litigation is anticipated, ensure document preservation occurs concurrently with the internal investigation.
- Provide legal advice, such as analysis of allegations of legal wrongdoing and recommendations for policy and practice changes, even if such advice is not included in the final report.
- Clearly communicate from the outset, including in the engagement letter and investigation plan, that the purpose of the investigation is to provide legal advice to the client.
- Relatedly, maintain a record of the investigation team's communications with in-house counsel and/or management apart from both the investigation itself and delivery of the final report. Such a record can support a finding that the purpose of the investigation was to provide legal advice.
- Use privilege legends judiciously and provide and memorialize *Upjohn* warnings to witnesses at the start of interviews, clarifying that the investigating attorney represents the company and is conducting the interview in order to provide legal advice to the company and instructing the witness to keep the interview confidential.
- Keep investigative materials, including reports and interview memoranda, confidential and share them only on a need-to-know basis and with parties clearly within the privilege.
- Finally, ensure that the method of disclosure of investigative materials reasonably maintains the confidentiality of the materials. *Wollman* illustrates that providing investigation materials to a person within the privilege via a potentially unsecure mode of communication (here, the board chair's unrelated work email address) may result in a waiver if third parties access those materials. In the current COVID-19 remote work environment, ensuring the confidentiality of communications takes on particular significance and requires understanding the technology being used.

As *Wollman* shows, attorneys who fail to follow best practices to protect internal investigation materials from disclosure at the outset of the investigation risk not only *in camera* review or disclosure of the material they seek to protect, but also broad subject-matter waiver beyond the material disclosed.

Notes

1. United States ex rel. Wollman v. Massachusetts Gen. Hosp., Inc., No. CV 15-11890-ADB, 2020 WL 4352915 (D. Mass. July 29, 2020).
2. In re Kellogg Brown & Root, Inc., 756 F.3d 754, 760 (D.C. Cir. 2014).
3. *Wollman*, 2020 WL 4352915, at *11.
4. Upjohn Co. v. United States, 449 U.S. 383, 101 S. Ct. 677, 66 L. Ed. 2d 584 (1981).
5. *See also* Edwards v. Scripps Media, Inc., No. 18-10735, 2019 WL 2448654, at *1–2 (E.D. Mich. June 10, 2019) (following *Kellogg*); In re Smith & Nephew Birmingham Hip Resurfacing Hip Implant Prod. Liab. Litig., No. 1:17-MD-2775, 2019 WL 2330863, at *2 (D. Md. May 31, 2019) (same); Pitkin v. Corizon Health, Inc., No. 3:16-CV-02235-AA, 2017 WL 6496565, at *4 (D. Or. Dec. 18, 2017) (same); In re Gen. Motors LLC Ignition Switch Litig., 80 F. Supp. 3d 521, 529–530 (S.D.N.Y. 2015) (same).
6. United States v. Kovel, 296 F.2d 918, 922 (2d Cir. 1961).
7. Fed. R. Civ. P. 26(b)(3)(A).
8. *Wollman*, 2020 WL 4352915, at *9.
9. *Id.*

STATE CORNER

Inspection Rights to Books and Records of Delaware Companies Are Governed by Delaware Law

By Gregory D. Beaman and Aaron J. Gold

On August 13, 2020, the Delaware Court of Chancery held that stockholders' rights to inspect the books and records of Delaware companies are exclusively governed by the Delaware inspection statute, 8 Del. C. § 220, regardless of whether the company is headquartered in another state with a different inspection rights statute.[1]

Factual Background

JUUL is a privately held Delaware corporation headquartered in San Francisco, California. On December 27, 2019, a JUUL stockholder (who also was a former employee) demanded to inspect the company's books and records under Section 1601 of the California Corporations Code, which, as Vice Chancellor Laster explained, "grants inspection rights to any stockholder in a corporation with its principal executive office in California, regardless of [the] corporation's state of incorporation."[2] JUUL challenged the inspection demand on the ground that, among other things, the demand was invalid because JUUL is a Delaware company and therefore the stockholder's inspection rights were governed exclusively by Delaware law.[3]

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The Court of Chancery's Decision

The Court of Chancery agreed with JUUL. Vice Chancellor Laster explained that "[s]tockholder inspection rights are a core matter of internal corporate affairs"[4] and, with limited exceptions, Delaware law governs the internal affairs of Delaware corporations.[5] The Vice Chancellor further noted that

> [a]n important public policy served by the internal affairs doctrine is to ensure the uniform treatment of directors, officers, and stockholders across jurisdictions, . . . "which can only be attained by having the rights and liabilities of those persons with respect to the corporation governed by a single law."[6]

"If other states could define the terms by which stockholders can inspect books and records," the court explained, "then a Delaware corporation could be subjected to different provisions and standards in jurisdictions around the country."[7] Thus, because inspection rights with respect to Delaware companies are a matter of internal affairs and therefore governed by Delaware law, the court held that the JUUL stockholder could not seek inspection under Section 1601 of the California Corporations Code.[8]

Takeaways

The *JUUL Labs* decision is important because stockholders strategically may seek inspection under other states' laws that provide broader inspection rights than those afforded under Delaware law. For example, Section 1600 of the California Corporations Code provides stockholders who meet certain ownership thresholds an "absolute right" to

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inspect the company's stockholder list,[9] whereas, under Delaware law, stockholders are not entitled to inspect a stockholder list if the company has demonstrated the demand is not for a "proper purpose."[10] As another example, Section 1604 of the California Corporations Code authorizes courts to award attorney fees to the stockholder if it determines the company's failure to comply with a proper inspection demand was "without justification,"[11] whereas the Delaware statute contains no such fee-shifting provision.[12]

JUUL Labs therefore provides Delaware companies an important tool to resist onerous or suspect inspection demands made under other states' laws. Of course, it remains to be seen whether courts in other jurisdictions adhere to the *JUUL Labs* decision when evaluating inspection demands on Delaware companies that have been made under the law of the court's home jurisdiction. For example, the result may have been different in *JUUL Labs* had the stockholder's demand under California law been challenged in a California court. The reason it was not is because JUUL initiated its challenge in Delaware, pursuant to the company's exclusive forum provision in its certificate of incorporation, which provided that all actions governed by the internal affairs doctrine were subject to the exclusive jurisdiction of the Delaware Court of Chancery.[13] Vice Chancellor Laster enforced the provision as applied to the California stockholders' inspection demand, given that inspection demands involve the "internal affairs" of the corporation.[14] To secure the benefits of the *JUUL Labs* decision, Delaware companies would be wise to include exclusive Delaware forum provisions in their corporate charters.

Notes

1. See JUUL Labs, Inc. v. Grove, No. 2020-0005-JTL, 2020 WL 4691916 (Del. Ch. Aug. 13, 2020).
2. *Id.* at *1.
3. *Id.*
4. *Id.* at *7.
5. *Id.* at *6–7.
6. *Id.* at *8.
7. *Id.* at *9.
8. *Id.* at *9–10.
9. *See* Cal. Corp. Code § 1600(a).
10. *See* 8 Del. C. § 220(b).
11. *See* Cal. Corp. Code § 1604.
12. *See* 8 Del. C. § 220.
13. *JUUL Labs*, 2020 WL 4691916, at *1, 10.
14. *Id.* at *10.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Arnold & Porter Kaye Scholer LLP
Washington, DC (202-942-5000)

SEC Approves NYSE Proposal to Permit Direct Listings (August 27, 2020)

A discussion of the SEC approval of a New York Stock Exchange (NYSE) proposal to allow a new type of direct listing that will permit a private company to list its common stock on the NYSE at the time of effectiveness of a registration statement pursuant to which the issuer will sell common stock to the public for cash in an open auction on the first day of trading. Nasdaq has filed a similar proposal with the SEC.

Baker & Hostetler LLP
Denver, CO (303-861-0600)

DOJ and SEC Publish New FCPA Resource Guide (August 13, 2020)

A discussion of the issuance of the second edition of the Resource Guide to the US Foreign Corrupt Practices Act (FCPA) by the Criminal Division of the Department of Justice (DOJ) and the Enforcement Division of the SEC.

M&A Consideration for Buyers of Targets with PPP Loans (August 7, 2020)

A discussion of the need for a buyer contemplating acquiring a target that has received a loan under the Paycheck Protection Program (PPP) to consider carefully how the target's PPP loan will affect the transaction in its due diligence, contract negotiation, and post-closing stages.

Bryan Cave Leighton Paisner LLP
St. Louis, MO (314-259-2000)

FINRA Reaffirms Settled Principle that Transaction-Based Compensation Typically Cannot be Paid to Unregistered Persons or Entities (July 29, 2020)

A discussion of a decision issued by the Financial Industry Regulatory Authority's (FINRA) final adjudicative body, the National Adjudicatory Counsel, affirming a Hearing Panel decision sanctioning Silver Leaf Partners, LLC for making improper payments to unregistered persons and entities.

Cadwalder, Wickersham & Taft LLP
New York, NY (212-504-6000)

Delaware Court of Chancery Further Clarifies the "Ab Initio" Requirement in Finding that Discussions between the Controlling Stockholder and a Minority Stockholder Precluded the Application of *MFW* (August 24, 2020)

A discussion of a Delaware Court of Chancery decision, *In re HomeFed Corp. Stockholder Litigation*, considering whether a squeeze-out merger by a controlling stockholder complied with the procedural framework set forth in *Kahn v. M&F Worldwide Corp* (*MFW*).

Cahill Gordon & Reindel LLP
New York, NY (212-701-3000)

Second Circuit Alleged Reckless Failure to Disclose Loan Was Sufficient to Give Rise to Inference of Scienter (August 27, 2020)

A discussion of a decision of the US Court of Appeals for the Second Circuit, *Setzer v. Omega*

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Healthcare Inv'rs, Inc., analyzing both the factors giving rise to a duty of disclosure and how to assess scienter in the context of the alleged recklessness nondisclosure.

Eversheds-Sutherland Ltd. Atlanta, GA (404-853-8000)

SEC Proposes Amendments to AFFE and Advertisements (August 14, 2020)

A discussion of SEC proposed modifications to the disclosure framework for mutual funds and exchange-traded funds, focusing specifically on the two proposed modifications that will impact business development companies, including one related to "acquired fund fees and expenses" (AFFE).

The Emerging Patchwork of Fiduciary Investment Advice Regulation (August 20, 2020)

A chart intended to assist firms subject to the number of fiduciary and best interest advice regulations at both the federal and state levels.

Faegre Drinker Biddle & Reath LLP Philadelphia, PA (215-988-2700)

SEC Warns Industry: Remain Vigilant of Cyberattacks (August 1, 2020)

A discussion of a risk alert issued by the SEC Office of Compliance Inspections and Examinations (OCIE) warning of a surge in cyberattacks.

SEC Proposes to Transform and Modernize Mutual Fund and ETF Disclosure Framework (August 2, 2020)

A discussion of a SEC proposal to adopt new Rule 498B under the Securities Act of 1933 (Securities Act) and corresponding changes to other rules and related changes to Forms N-1A and N-CSR. The proposal is designed to: (1) streamline the content of shareholder reports; (2) change certain prospectus and advertising disclosures; and (3) change prospectus and shareholder report delivery requirements of open-end investment companies.

Fenwick West LLP Mountain View, CA (650-988-8500)

Proposed Form 13F Changes Would Reduce Visibility into Stockholder Base and Activist Activities (August 18, 2020)

A discussion of SEC proposed amendments to the filing requirements for Form 13F, which is expected to decrease the number of institutional investment managers required to report quarterly investment holdings by almost 90 percent.

Key Metrics for US Technology and Life Sciences Initial Public Offerings (August 2020)

A survey of initial public offerings by US technology and life sciences companies during the first half of 2020.

Terms of IPO Lock-Up Agreements for Technology Companies Shift as Direct Listings and SPACs Gain Traction (August 31, 2020)

A discussion of a survey finding that the length of initial public offering (IPO) lock-up agreements for technology companies continues to be predominately 180 days but that lock-ups increasingly are subject to early release provisions in connection with trading blackouts and, in certain cases, achievement of performance-based milestones tied to stock price.

Gibson, Dunn & Crutcher LLP Los Angeles, CA (213-329-7870)

Shareholder Proposal Developments During the 2020 Proxy Season (August 4, 2020)

A discussion of shareholder proposals submitted to public companies during the 2020 proxy season, including statistics and notable decisions from the SEC Staff on no-action requests.

2020 Mid-Year Securities Litigation Update (August 10, 2020)

A discussion of a variety of securities-related lawsuits in the first half of 2020, including securities

class actions, insider trading lawsuits, and government enforcement actions.

Haynes and Boone, LLP
Dallas, TX (214-651-5000)

SEC Issues Risk Alert Outlining Various Compliance Risks and Issues Applicable to Investment Advisers (August 18, 2020)

A discussion of two risk alerts issued by OCIE, including: (1) observations from examinations of advisers to private funds; and (2) select COVID-19 compliance risks and issues.

Holland & Hart LLP
Denver, CO (303-295-8000)

Overcoming M&A Due Diligence Hurdles in "New Normal" Transactions (August 5, 2020)

A discussion of conducting due diligence in the age of COVID-19, including such issues as document production, security and privacy concerns, and in-person interactions.

10 Tips to Mitigate the Risk of Deal Breakups in the Era of COVID-19 (August 12, 2020)

A discussion of how parties can proactively mitigate the risks of not closing in mergers and acquisitions in the era of COVID-19.

Hughes Hubbard & Reed LLP
New York, NY (212-837-6000)

Deal Price v. Appraised Value (August 2020)

A discussion of a Delaware Supreme Court decision, *Fir Tre Value Master Fund, LP v. Jarden Corp.*, further clarifying the applicable principles when determining the fair value of shares. It affirms a Court of Chancery decision pursuant to which the value of shares was determined to be the unaffected market price (the price before the news of a potential transaction was known in the marketplace.

Hunton Andrews Kurth LLP
Richmond, VA (804-788-8200)

Disclosing a Government Investigation During a Securities Offering (July 2020)

A discussion of what disclosures public companies should consider for SEC filings during the pendency of a government investigation.

Jones Day LLP
Cleveland, OH (216-586-3939)

SEC Enforcement in Financial Reporting and Disclosure: Mid-Year 2020 Update (August 2020)

A discussion of SEC enforcement activity for the first half of 2020 and other developments relating to financial reporting and issuer disclosure.

DGCL Amendments (August 2020)

A discussion of amendments to the Delaware General Corporation Law (DGCL) to address emergency bylaws and related powers exercised by a corporation's board of directors, as well as with regard to dividends. Additionally, amendments clarify certain provisions regarding indemnification.

Paul, Weiss, Rifkind, Wharton & Garrison LLP
New York, NY (212-373-3000)

Update for Chinese SEC Reporting Companies (August 7, 2020)

A discussion of a report issued by the US Treasury Secretary on behalf of the President's Working Group on Financial Markets addressing the risks to US investors posed by the continuing constraints imposed by the Chinese government on access by the Public Company Accounting Oversight Board to

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audit work papers of auditors of Chinese companies listed in the United States.

New York State Refuses to Vacate Stay of Securities Act Case (August 8, 2020)

A discussion of a New York Supreme Court decision, *In re NIO Inc. Securities Litigation*, in which the court refused to vacate his stay of a class action under the Securities Act in favor of a parallel first-filed federal court suit, despite plaintiffs' argument that the proposed amended state complaint included allegations and defendants that were not included in the federal action.

Perkins Coie LLP
Seattle, WA (206-359-8000)

Making Sustainability a Stakeholder (August 4, 2020)

A discussion of the fiduciary duties owed by directors and an alternative corporate governance model and corporate form that is gaining traction among branded companies—public benefit corporations.

Investor Focus on Sustainability (August 10, 2020)

A discussion of investors clamoring for regular reporting on corporate sustainability efforts and achievements and public company sustainability drivers, obligations, and options.

Rare DOJ Opinion Offers Anti-Bribery Lessons (August 20, 2020)

A discussion of a DOJ opinion letter stating that it does not intend to take enforcement action under the FCPA against a US-based investment advisor planning to pay something akin to a "finder's fee" to a foreign owned investment back.

Proskauer Rose LLP
New York, NY (212-969-3000)

SPAC IPO Study (August 4, 2020)

A study examining data from 95 Special Purpose Acquisition Company (SPAC) initial public offerings priced from January 2016 through June 2020, representing over half of the SPACs listed on the US exchange.

PIPE Transactions (August 18, 2020)

A discussion of key considerations for issuers and investors contemplating a private investment in public equity, a PIPE transaction, which is an increasingly used method of equity financing in the current market environment.

ReedSmith LLP
Pittsburgh, PA (412-288-3131)

Delaware Court of Chancery Clarifies the Prerequisites for Valuing a Stockholder's Interest under DGCL Section 220 (August 4, 2020)

A discussion of a Delaware Court of Chancery decision involving Sahara Enterprises, Inc., holding that a stockholder seeking records from a corporation to value its interest in a Delaware corporation under DGCL Section 220 need not explain why the stockholder seeks to value its interest.

Delaware Supreme Court Clarifies Standard When Limited Partners Seek Books and Records (August 4, 2020)

A discussion of a Delaware Supreme Court decision, *Spencer L. Murfey, III, et al. v. WHC Ventures, LLC, et al.*, holding that limited partners who were seeking partnership tax records under the terms of a partnership agreement were not required to meet the

"necessary and essential" showing because the partnership agreement did not explicitly condition the inspection rights upon proving that the tax records were "necessary and essential" to their stated purpose.

Ropes & Gray LLP
Boston, MA (617-951-7000)

Taking a Fresh Look at Delaware Public Benefit Corporations (August 4, 2020)

A discussion of the Delaware public benefit corporation law and the most recent amendments to such provisions in July 2020.

Seward & Kissel LLP
New York, NY (212-574-1200)

Special Committee Must Be Formed before Economic Discussion Begins (August 1, 2020)

A discussion of a Delaware Court of Chancery decision, *Salladay v. Lev*, holding that a special committee can cleanse a conflicted, non-controller transaction only if the special committee is established from the outset, before any substantive economic discussions have occurred.

SPACs Are Back (August 14, 2020)

A discussion of SPACs, companies with no initial assets or operations that raise capital through an IPO, with the IPO proceeds held in trust for up to a defined period of time for the purpose of acquiring a private business.

SEC Charges Private Equity Adviser for Misallocated Expenses (August 17, 2020)

A discussion of a settled SEC enforcement order against a private equity fund adviser Rialto Capital Management, LLC for misallocating expenses relating to the performance of certain "Third Party Tasks" to two real estate private equity funds it managed.

Shearman & Sterling LLP
New York, NY (212-848-4000)

CEO Pay Ratio—Three Year Refresher (August 12, 2020)

A discussion of the SEC rules for selecting a median employee under the CEO pay ratio disclosure requirement and additional related disclosure considerations to keep in mind if a company instituted reductions in force this year due to COVID-19.

Sidley Austin LLP
Chicago, IL (312-853-7000)

SEC Broadens Accredited Investor and Qualified Institutional Buyer Definitions (August 28, 2020)

A discussion of the SEC's adoption of amendments to the definitions of "accredited investor" and "qualified institutional buyer" to bring additional categories of persons and entities within the scope of the definitions.

Weil Gotshal & Manges, LLP
New York, NY (213-310-8000)

SEC Reaches Milestone in Road toward Proxy Process Reform (August 18, 2020)

A discussion of the SEC adoption of amendments to key rules under Section 14 of the Securities Exchange Act of 1934 governing the activities of what the SEC terms "proxy voting advice businesses."

White & Case LLP
New York, NY (212-819-8200)

ESG Disclosure Trends in SEC Filings (August 2020)

A discussion of an annual survey of ESG disclosure in SEC filings by the top 50 companies by revenue in the Fortune 500.

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