Skadden

The Informed Board

Winter 2023

In the current environment, tax-free spin-offs may be the best option for companies focusing their business lines, we explain in this issue of *The Informed Board*. Spin-offs do not depend on third parties, and they preserve flexibility on timing and structure.

European companies expect more activist campaigns and, in the U.S., new proxy voting rules could help dissidents win board seats. Meanwhile, the SEC has restricted directors' preset stock trading plans, and even multinationals based outside the EU need to prepare for EU rules requiring climate impact and risk disclosures.

Finally, Foot Locker's chair discusses how self-evaluations can make boards more effective.

Putting the Best Spin on Corporate Splits

- Companies are likely to see continued pressure from both institutional investors and activists to separate businesses that are not deemed "core" and thereby generate higher equity multiples for the parent or the separated business.
- Tax-free spin-offs and similar transactions may be the most appealing way to separate a business, in part because companies retain flexibility during the process to change the structure of the transaction, and they can entertain third-party bids while pursuing a spin-off.
- Spin-offs are less dependent on third parties and market conditions, so the company has more control over the timing of a separation, which helps to unlock value on the company's chosen timeframe.

In recent years, in the boardrooms of public companies with multi-line businesses, there have been few louder drum beats than those from investors calling for divestitures, spin-offs or other separation transactions aimed at increasing "corporate clarity."

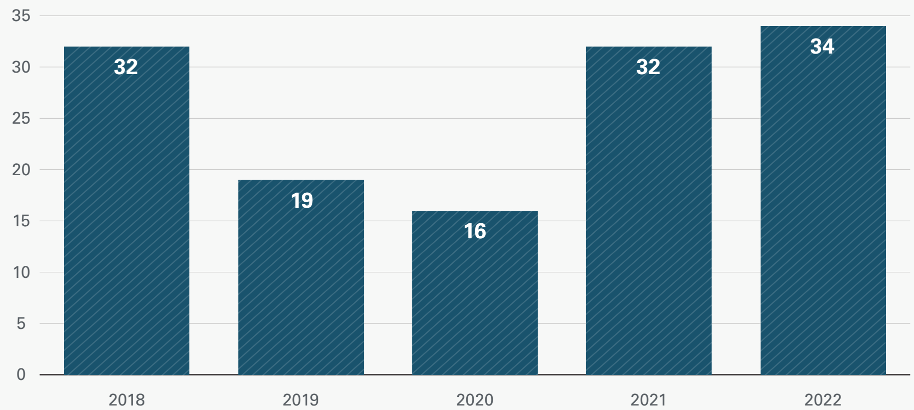
Separation transactions find their way onto board agendas at the behest of both long-term institutional investors searching for "pure play" opportunities and activist investors, who initiated seven proxy campaigns centered around corporate break-ups in the third quarter of 2022 alone.

Against this backdrop, companies have responded with an increasing number of separation transactions, announcing $2.3 trillion of carve-outs globally in 2021 and more than 30 significant U.S. spin-off transactions in 2022.

As 2023 unfolds, boards and management can anticipate even more calls to "unlock value" by separation. One catalyst is the capital markets, where equity multiples generally have declined but growth sectors and businesses with predictable cashflows sometimes command premiums. Another factor is increased shareholder activism in response to the uncertain outlook for corporate performance due to macro-economic factors like higher interest rates, inflation and hampered demand.

As boards and management teams evaluate business portfolios and potential separation transactions, they confront an M&A environment in which carve-out sales face headwinds, including mismatches between buyer and seller valuation expectations, increased financing costs due to higher interest rates and market dislocation, uncertainty around the macro-economic outlook and increasingly aggressive regulatory reviews.

Spin-offs announced by U.S. companies



Source: Deal Point Data

Faced with such an uncertain environment, boards and management teams contemplating separations would be well-advised to consider carefully spin-off and similar transactions like Morris Trusts, Reverse Morris Trusts, split-offs and incubator joint ventures — transactions we will refer to collectively as spin-offs. If well designed, these can not only unlock value for shareholders, but leave the company with flexibility regarding the final structure, so they can pivot along the way in response to input from shareholders or changing market conditions.

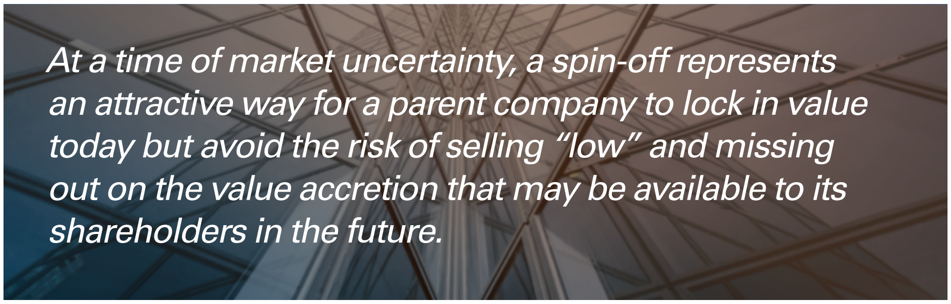
Why Pursue a Spin-Off Transaction to Unlock Value?

The Value Proposition

Board analysis of a spin-off, like any other proposed transaction, begins with the value proposition.

From a corporate growth perspective, spin-offs can improve returns by better aligning pay and performance for businesses leaders, providing equity currency for future transactions that is more closely linked to the characteristics of each business, and focusing management on improving organic business performance and growth. However, the upside must be weighed against one-time transaction costs and cost dis-synergy stemming from maintaining separate corporate infrastructures and loss of scale.

One of the chief advantages to the parent company of a spin-off, where a new public company is created around a business line or asset, is that the transaction does not entail any tax liability to the parent, as a straight sale to a buyer typically would. In situations where the parent's tax basis in the separated business is low (and there would thus be a large taxable gain) but valuations are not robust enough to compensate for the tax burden, the tax-free nature of a spin-off alone may lead the parent to favor that form of transaction.



Moreover, the parent company may be able to bolster its balance sheet through a cash distribution to the parent before the spinoff (up to the level of its tax basis) and by issuing new debt of the spin-off company in exchange for existing debt owed by the parent.

Spin-offs offer similar tax advantages to parent shareholders, who receive valuable shares in a new public company without recognizing a taxable gain. In addition, when the equity markets attach a higher multiple to the new spin-off company, or the remaining parent company, because of a better growth profile or alignment with comparable companies, shareholders may see an immediate value uplift, as well as the potential for future gains through improved earnings growth or a later sale of the spun-off business.

At a time of market uncertainty, a spin-off represents an attractive way for a parent company to lock in value today but avoid the risk of selling "low" and missing out on the value accretion that may be available to its shareholders in the future.

Maximum Optionality to Control Timing and Pivot to a Third-Party Sale

Often boards and management teams analyzing a separation conclude that the business under consideration has its own life cycle that demands a break from the parent. Separation may be necessary to properly allocate capital for growth, to attract talent through management incentives, or to pave the way for growth through acquisitions. However, there may not be third-party interest at the time or current valuations may not be attractive.

Unlike a carve-out sale, boards can choose to announce a spin-off when the parent company and the separated business are ready, regardless of other market players. In our experience, when a spin-off can be consummated hinges mainly on the preparation of carve-out and *pro forma* financials for the securities registration statement, and on the board's and management's determination that the spin-off company's growth and business case has been fully developed and will support a healthy market valuation. These are largely under the control (or at least the purview) of the parent.

Moreover, the board and management can continue to evaluate their course of action in response to changing circumstances after announcement of the spin-off. Indeed, frequently the information package provided in preliminary registration statement filings prompts interest from third-party buyers, who may not have been available when the transaction was initially considered. We believe that this may become even more common in 2023 as developments in the financing markets and other aspects of the M&A ecosystem unfold.

Importantly, a company that has announced plans for a spin-off can, with the proper tax advice, entertain indications of interest, and even engage in discussions with potential buyers. However, if a third party that participated in negotiations does not agree to a sale pre-spin and then buys the separated business after the spin-off, that can jeopardize the tax-free treatment in some circumstances, so caution must be exercised. Consideration should be given to pursuing any discussions as early as possible after spin-off announcement, both to minimize management distraction and to limit any restrictions on buyers after the spin-off.

Flexibility to Structure a Spin-Off in Response to Shareholder Input

While shareholders may help to catalyze the consideration of a spin-off, often a full understanding of shareholders' preferences can only be gleaned after the spin-off has been publicly announced. But, again, the spin-off process allows boards and management to react to shareholder preferences regarding the scope of the business to be separated, capital structure and other attributes of the spin-off company after the preliminary registration statement is filed.

In fact, in our experience, it is increasingly common for companies to meet proactively with shareholders following announcement of a spin-off to solicit their input and assess how best to reflect that in the terms and structure of the transaction. In particular, when the business line under discussion is relatively distinct from the parent's other businesses, some parent shareholders may not be eager to receive the spun-off company's stock. In such cases, boards and managements should consider maintaining the option in registration statement filings to structure the separation as a split-off.

Unlike a spin-off, where all parent shareholders receive shares of the spun-off company pro rata, a split-off is structured as an exchange offer where each parent shareholder is given the choice to exchange some of its parent shares for the split-off company's shares. This allows for a targeted distribution of the separated company's shares to the parent shareholders who most desire to hold them, while delivering the benefits of a buyback of a portion of the parent company's shares. In order to maximize shareholder choice, boards and management can obtain input from shareholders regarding their receptivity to a split-off after announcement of the separation.

Conclusion

In 2023, boards can expect to be called upon frequently to guide management teams as they consider separation transactions advocated by investors. Given the current dislocation in the macroeconomic environment and other sources of uncertainty, pursuing a spin-off may offer near-term advantages. A spin-off can deliver value without triggering tax, it does not require the participation of third parties, and can be less dependent on market conditions than a sale. Moreover, companies can tailor a transaction in response to shareholder input and alter course to capture value through a sale before consummation of the spin-off, or leave open the possibility that the newly independent business will be acquired after it is spun off.

Authors

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How the New Proxy Rules Will Affect US Companies Facing Activist Campaigns

- New "universal" proxy card rules may increase the number of activist campaigns if activists believe the rules give them a better chance to win seats in contested elections. Smaller companies may be most vulnerable.
- But the benefits to activists may be only marginal, particularly in the case of large cap targets with relatively few retail shareholders.
- The new rules focus attention on individual directors' qualifications, so companies will need to articulate nominating individuals, particularly those with potential vulnerabilities.
- Proxy advisory firms do not appear to have altered their historical approaches to determining which nominees to support.
- Because the rules make contested elections less predictable, the changes could increase pressure on companies to reach settlements with activists.

Shareholder meetings held this year are subject to new rules that require both companies and activist shareholders to use "universal" proxy cards in contested board elections. Until now, the company and the dissident shareholder each distributed their own cards with only their candidates, so shareholders who did not attend the meeting and voted by proxy were forced to choose between the two cards, *i.e.*, between full, competing slates.

The new rules, adopted by the Securities and Exchange Commission (SEC) last year, require both sides to list *all* candidates — their slate and the alternative nominees — on their respective cards. This allows shareholders to "mix and match," picking some company and some activists nominees. In the past, only shareholders attending the meeting in person could do that. The rules apply to most public company shareholder meetings held after August 31, 2022.

The goal of the rules is to give shareholders more power over the exact shape of the board, and the change may make it somewhat easier for dissident shareholders to win board seats.

Only a Few Elections Have Taken Place Under the New Rules So Far

Since most annual meetings are held in the spring, few contested elections have been launched since the rules came into effect. Skadden represented the companies in the first two proxy fights under the new rules, offering a glimpse of how such contests may be altered (or not) by the new rules:

- Activist Land & Buildings sought two of the three seats up for election on the classified board of Apartment Investment and Management Co. (Aimco).

    - Land & Buildings won one seat, in accord with one proxy advisor's recommend
- Capital Returns Management sought two of the seven board seats at Argo Group International Holdings.
    - Facing a likely defeat at the ballot box, in part because proxy advisory firms did not recommend its nominees, Capital Returns withdrew its nominations.

What Do the New Proxy Cards Look Like?

The new rules require both the company and the dissident to list all nominees on their respective proxy cards in a clear, neutral manner. The rules do not, however, specify the order in which nominees are listed.

In both the Aimco and Argo elections, the companies' and the activists' proxy cards each clearly distinguished between the company and dissident candidates and contained recommendations of the soliciting parties. The activists also indicated which company nominees were acceptable to them and which they opposed.

Trian Fund Management, L.P. followed a similar format in the proxy fight with The Walt Disney Company before withdrawing its nomination in early February.

The Rules Put the Spotlight on Individual Directors

In the past, a dissident stockholder would typically argue that its slate of nominees, taken as a whole, was more qualified or better positioned to enhance stockholder value than the company's nominees, taken as a whole. However, now that stockholders can mix and match candidates from either slate, there appears to be enhanced scrutiny on the qualifications of individual nominees. In both the Aimco and Argo contests, the companies and dissidents focused a great deal on the qualifications of their individual nominees, and criticized the qualifications of the opposing nominees.

Likewise, Trian specifically targeted one Disney director, presumably based on a belief that it had the best chance of winning one seat with this approach.

The upshot is that companies will need to (a) clearly communicate their strategy for board refreshment and composition as a whole, and (b) pay particular attention to individual directors who may be vulnerable to an attack due to factors such as long tenure, service on multiple boards, either a perceived lack of relevant expertise or skill sets, or redundancy of expertise on the board.

In both the Aimco and Argo contests, the companies and dissidents focused a great deal on the qualifications of their individual nominees, and criticized the qualifications of the opposing nominees.

Proxy Advisory Services Do Not Appear To Be Altering Their Approaches

Based on a review of Institutional Shareholder Services' (ISS's) and Glass Lewis' reports, it appears that Glass Lewis takes a more holistic view of a dissident's thesis and it continues to be "reticent to recommend the removal of incumbent directors ... unless certain issues are evident," such as poor corporate governance oversight.

In Argo's contest, ISS and Glass Lewis both recommended voting for the company's nominees. At Aimco, their advice diverged. Glass Lewis supported the company's nominees, but ISS split its recommendation, advising a vote for two company nominees and one Land & Buildings candidate.

In an example of increased scrutiny of individual nominees, ISS said it declined to support one incumbent Aimco director because he was long-tenured and his qualifications were similar to those of more recently appointed independent directors, and the qualifications and background of one of Land & Buildings' nominees would better complement the current Aimco directors.

While one cannot draw firm conclusions from two proxy contests, it appears that, to date, neither ISS nor Glass Lewis has modified its general framework for evaluating election contests for a minority of the board of directors.

Do Bylaws Need To Be Amended?

Some companies, including 145 of the Fortune 500 as of February 7, 2023, have amended their bylaws in response to the new rules. Many of the amendments closely track the amended rules — requiring, for example, that an activist provide evidence that it solicited proxies from at least 67% of stockholders, as the rule requires. Others have included tangential bylaw amendments: For example, 79 Fortune 500 companies now reserve the right to use a "white" card, which some see as an advantage because they are traditionally identified by shareholders as the company's.

Amending a company's bylaws to include new rules may provide some procedural advantages. For instance, if the company believes an activist has not complied with the new rules, it can simply cite its bylaws; it does not need to wait for the SEC to enforce the rules.

At this early stage, there are a number of reasons to be cautious about bylaw amendments:

- Because the SEC rules are statutory mandates, it is not strictly necessary to amend bylaws to reflect the changes. We expect the SEC to vigorously enforce the new rules if activists skirt them, particularly in contests involving large companies. And the larger, more sophisticated activists that tend to target large companies are less likely to break the rules.
- Becoming an early adopter of bylaw amendments may draw attention to a company, potentially prompting speculation that the company is concerned about an activist campaign.
- Amendments that are seen as "aggressive" may convey a negative "defensive" or "entrenching" posture to shareholders and proxy advisory services, which could color their views of the company's governance negatively.

The Big Picture

As the 2023 proxy season plays out, it will become clearer if and how the rules alter the dynamics of board contests and, if they do, how companies should respond.

In the meantime, the changes appear to have made the outcomes of these fights somewhat less predictable. To the extent either activists or companies think the new rules increase the odds of activists prevailing, that may spur more campaigns and put pressure on companies to reach settlements with activists. They are also almost certain to make these contests increasingly turn on the qualifications of individual nominees.

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European Activism: More Attacks, More Engagement, More ESG Coming in 2023

For the third year, Skadden's European M&A practice has worked with Activistmonitor to survey executives from leading European companies and activist investors to assess their expectations for shareholder activism in Europe over the next 12 months. In this article we summarize the key findings.

– The number of live activist campaigns in Europe grew again in 2022, and companies expect to see more in 2023, according to a survey conducted by Activistmonitor and Skadden.

– Most companies surveyed have spotted weaknesses that could make them vulnerable to activists, and are addressing these.

– ESG issues increasingly figure in European activist campaigns, often alongside other more traditional themes such as governance matters, potential M&A transactions, share buybacks and other approaches to improving shareholder returns.

Major themes we expect to see in 2023 based on the survey include:

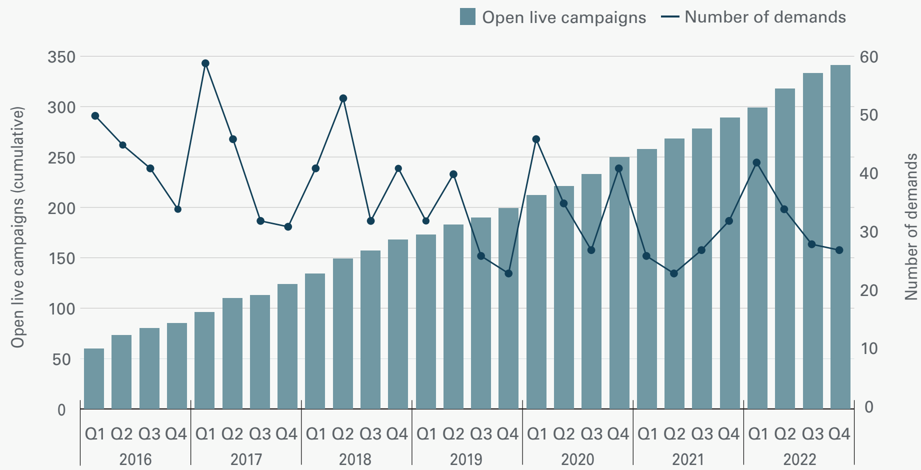
– **More campaigns:** 86% of corporations identified new weaknesses that could be raised by activists. Corporations with a market capitalization exceeding $2 billion were much more likely to be targeted.

– **More engagement:** 71% of the corporations responding anticipate an increase in shareholder activism and, of those, 48% expect a significant increase.

– **More ESG:** 96% of respondents expect that activists will increasingly prioritize ESG issues in their demands.

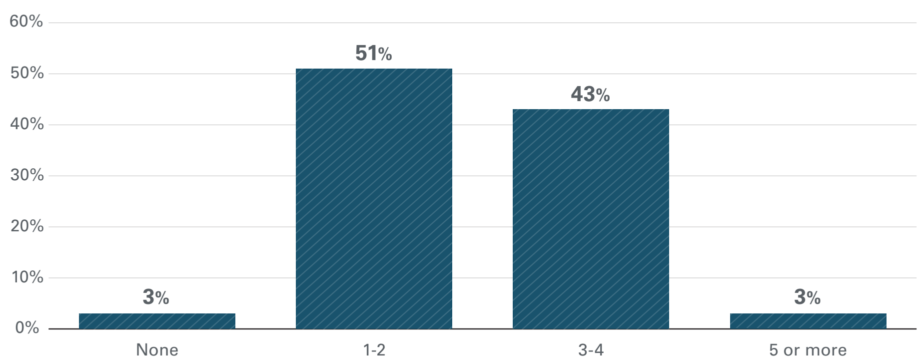
The number of open live campaigns in Europe increased to 341 in December 2022, including 52 campaigns launched in 2022. The largest number of new campaigns were in the United Kingdom (25) and Germany (eight).

Live campaigns in Europe



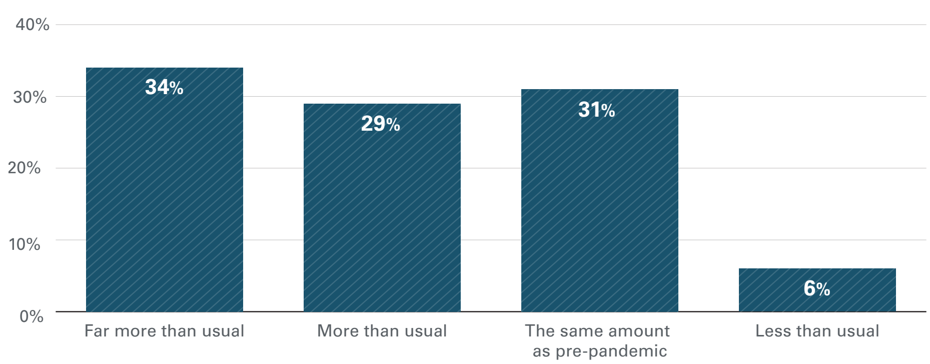
Many corporations have been approached by activists more than once in the past year — 46% at least three times.

Over the last 12 months, how often has your board been approached (privately or publicly) by activists?



Board discussions of the threat of activist campaigns became more frequent in the past year, according to 63% of the responding corporations.

Over the last 12 months, how often has your board proactively discussed the threat of activist campaigns?



Corporations with a market capitalization exceeding $2 billion were much more likely to be targeted.

Total campaigns by market capitalization (live and potential)

Market cap	2021	2022	Growth
<US$1bn	16	17	6%
US$1bn-US$2bn	5	5	0%
>US$2bn	18	30	67%
Total	**39**	**52**	**33%**

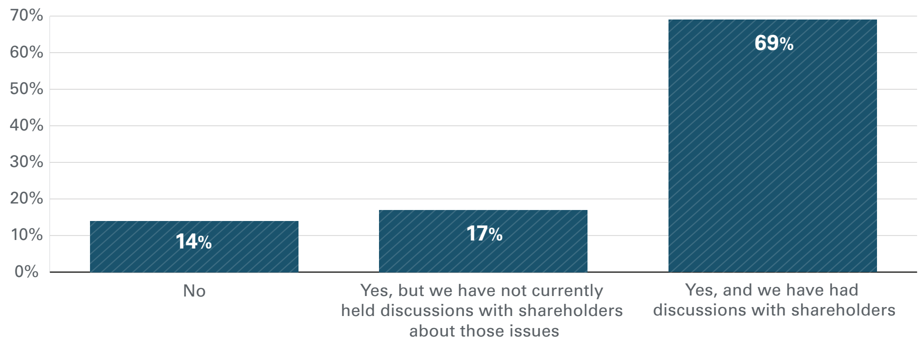
The types of demands made by activists continue to be varied, with particularly sharp increases in demands regarding cost reductions and operational improvements and demands opposing acquisitions and mergers.

Demands made in open live campaigns

	2020	2021	2022	Y-o-Y 2022
Discussions	7	0	2	NA
Cost reductions/operational improvements	14	5	18	260%
Share buy-back/dividend/return of capital	9	8	4	-50%
Acquisition/merger	3	3	4	33%
Oppose acquisition/merger	8	6	23	283%
Bolt-on/divestiture/spin-off	13	14	9	-36%
Oppose bolt-on/divestiture/spin-off	1	4	0	-100%
Strategic alternatives	10	6	11	83%
Capital allocation/structure changes	10	4	0	-100%
Governance changes	15	15	13	-13%
Management/board changes	16	17	26	53%
Board member(s) appointment	22	18	15	-17%
Environmental/social changes	2	1	0	-100%
Total	**130**	**101**	**125**	**24%**

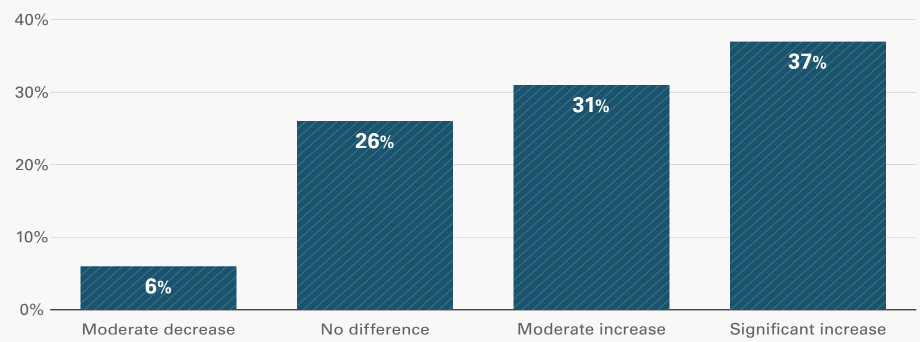
Corporations are concerned about new weaknesses being identified and serving as the basis for attacks by activists.

Over the last 12 months, have you identified any new weaknesses that could be raised by activists in potential campaigns?



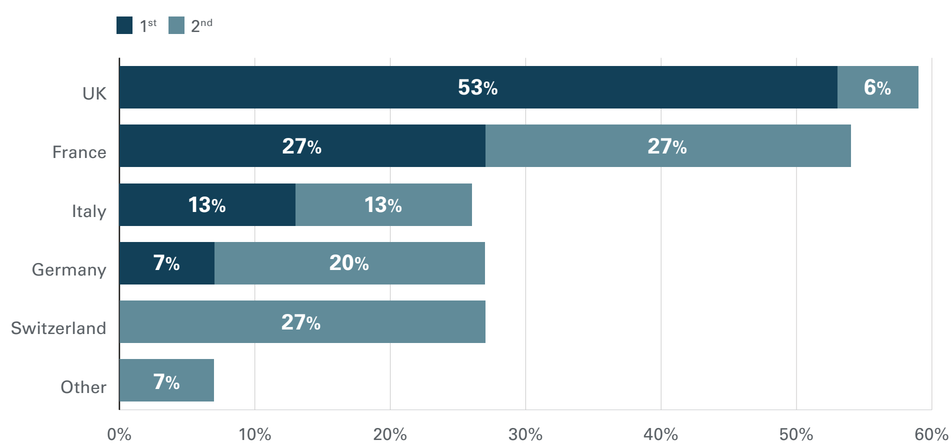
Increased activist activity is expected to lead to a greater number of unsolicited or hostile takeovers.

How do you expect the volume of unsolicited or hostile takeovers in Europe to change over the next 12 months?



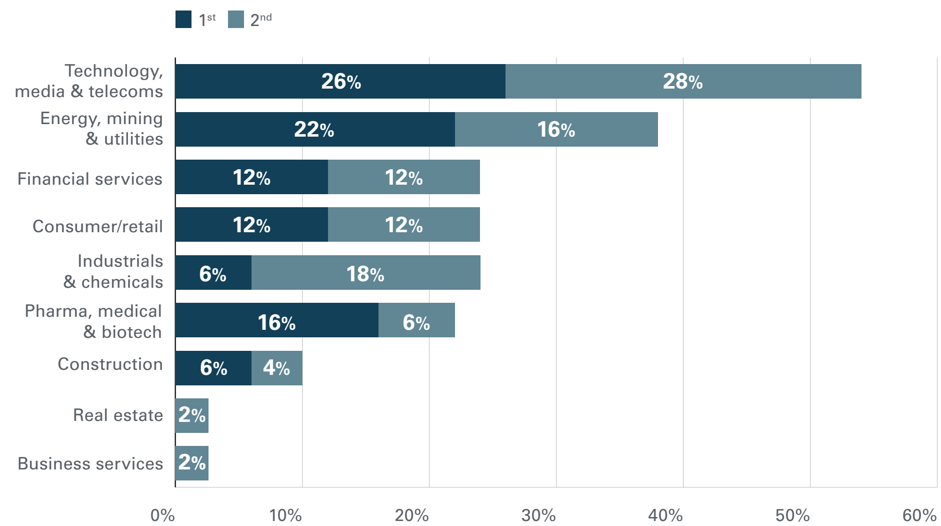
Attacks are expected to continue across Europe ...

Which European markets do you expect to offer the best opportunities for activist campaigns over the next 12 months (top two, ranked)?



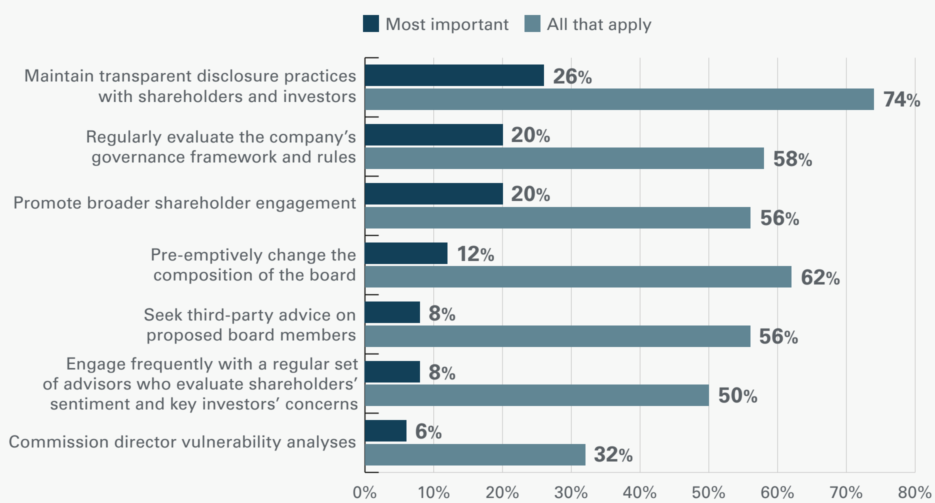
… and across a wide range of industry sectors.

In Europe, in which industries do you expect to see the most activist campaigns over the next 12 months (top two, ranked)?



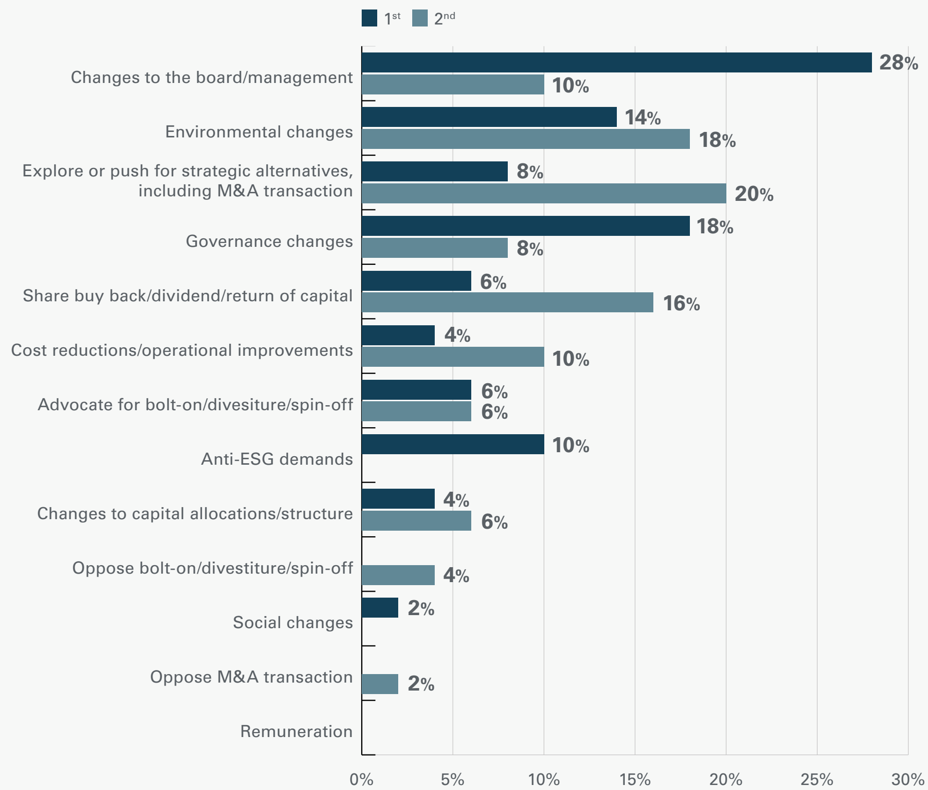
Given the level of attention, corporations expect to spend ever more time engaging with activists in the coming year.

In your view, what are the most effective preventative measures that companies can use to mitigate the chances of activist campaigns?



Environment, social and governance issues are expected to figure prominently in activists' demands in 2023.

Of the various categories of activist demands, which of the following do you believe will be the most prevalent in Europe over the next 12 months (top two, ranked)?



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This article is from Skadden's *The Informed Board.*

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FAQ: What the SEC's New Insider Trading Rules Mean for Directors

– New SEC rules on Rule 10b5-1 preset trading plans for insiders add lengthy "cooling-off periods" for directors and officers between the time they establish a plan and the date a first trade can be made.

– Most multiple overlapping plans and single-trade plans are now prohibited.

– The good faith requirement has been expanded and directors and executives will now have to certify when they create or modify a plan that they are acting in good faith and have no material nonpublic information.

– Companies will be required to disclose individuals' 10b5-1 plans in detail every quarter, and itemize annually all options awarded to top executives around the time of significant SEC filings.

In December 2022, the U.S. Securities and Exchange Commission (SEC) modified the rules governing preset stock trading programs for corporate insiders, known as 10b5-1 plans, which begin taking effect this year. The new rules will require directors, executives and other insiders to rethink their own preplanned trading programs, and companies will need to revisit their policies, and disclosure controls and procedures.

Below are answers to questions you may have. These are simplified and omit some conditions, exceptions and other details, so consider this just an overview and introduction.

What's behind the changes?

The SEC's Rule 10b5-1 allows insiders to establish preset plans to trade their companies' securities in the future. If a plan complies with the requirements, it can be used as an affirmative defense to any claim that the insider's trades were based on material nonpublic information.

The new rules reflect concerns that some insiders have gamed the rules, arranging advantageous trades based on inside information.

How will this affect my 10b5-1 plans?

Existing plans are not affected, but the rules will apply to any modifications as well as new plans starting February 27, 2023, so directors and officers may confront the new rules soon.

Cooling-off period. In the past, unless restricted by a company's own insider trading policy, an insider could adopt a plan that called for trades to commence almost immediately. Under the amended rules, trades under a director's or officer's plan cannot begin until at least:

(a) 90 days after the adoption or modification of their trading plan, or

(b) two business days after the company files a quarterly or annual financial report with the SEC covering the quarter in which the plan was adopted or modified,

whichever is later, but no later than 120 days after the plan is established.

Limits on multiple overlapping plans. Individuals generally will be prohibited from having more than one 10b5-1 plan covering the same time period for open market purchases or sales. An individual will be allowed to have two separate 10b5-1 plans for open market transactions only if trading under one does not commence until all trades under the other have been completed. (There is an exception for plans covering sales needed to satisfy tax withholding obligations triggered by the vesting of equity compensation.)

Limits on single-trade arrangements. At present, many 10b5-1 plans are set up for a single trade. Under the revised rules, a person will be limited to one single-trade plan in any 12-month period (with the same exception for tax withholding obligations).

What does "an expanded good faith duty" mean?

There are two significant changes here.

Under the old rules, to qualify as a 10b5-1 plan, it only had to be entered into in good faith. The new rules require *a written certification* from directors and officers when adopting or modifying a 10b5-1 plan that he or she (a) is not aware of material nonpublic information about the company or its securities and (b) is adopting or modifying the plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b-5.

In addition, good faith will be tested not just at inception of the plan. For a plan to qualify as an affirmative defense under the new rules, the person must have "acted in good faith with respect to" the plan, thus extending the good faith requirement throughout the duration of the plan.

Of particular note, the SEC said that influencing the timing of a company's disclosure so that trades under a plan are more profitable would run afoul of this ongoing good faith requirement.

What kind of disclosures will be required?

Companies will be required to disclose annually whether they have insider trading policies and procedures governing the trading by directors, officers and employees, and those policies must be included as an exhibit to the company's annual financial report filed with the SEC.

Of particular relevance to directors and officers, companies will be required to (a) disclose quarterly whether any director or officer has adopted, modified or terminated a Rule 10b5-1 plan or other trading arrangement and (b) describe the material terms of each plan adopted, modified or terminated, including the name and title of the director or officer; the date the plan was adopted, modified or terminated; the plan's duration; and the total amount of securities to be purchased or sold under the plan. Pricing terms need not be disclosed.

So my trading plans will be made public?

Yes, the details of the plans will be public, but without pricing information.

What are the new rules on option awards?

Under the amended rules, each year companies will need to state (a) how the timing of option awards is decided, (b) if and how material nonpublic information is considered when determining the timing and terms of awards, and (c) whether disclosure of that information is timed to affect the value of executive compensation.

Companies also will be required to disclose each year any options awarded to named executive officers within four business days before or one business day after quarterly financial filings or "current reports" that disclose material nonpublic information. Companies need to disclose:

– each award (including the grantee's name, the number of securities underlying the award, the grant date, the fair value on the grant date and the option's exercise price); and

– the percentage change in market price of the securities underlying each option award on the trading day before and after the company's disclosure of the material nonpublic information.

Do any of the changes affect corporate share repurchases?

Not at present, but the SEC said it is considering whether rule changes are necessary for open-market share repurchases by companies.

What will boards need to think about now that the new rules are taking effect?

Different parts of the amendments take effect on different dates over the next year. Your company's legal and compliance departments will handle the details of complying with the new rules. But, as a director, you may be involved in broader issues the changes raise:

– Insider trading policies and guidelines may need to be revised.

- Companies should consider what controls and procedures they will need to comply with the new disclosure requirements.
- Boards may need to revisit the schedule for compensation committee meetings in light of the new disclosure rules regarding option grant practices generally, and specifically for options granted to named executive officers close in time to a quarterly financial filing or other release of material nonpublic information.

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Multinationals Need To Revisit Their Reporting as New EU Sustainability Disclosure Rules Bite

- New EU-mandated environmental disclosures will apply to many multinationals based outside the EU if they have EU operations.
- Third-party audits of environmental information will be required, but the EU may not release detailed standards for those until 2026.
- Companies will need to decide whether to limit disclosures to their EU affiliates or make enterprise-wide disclosures.
- With no uniform, global set of ESG standards, multinationals may face diverging reporting obligations.

At the end of 2022, the European Union adopted a law mandating detailed environmental disclosures and, for the first time, extending its non-financial disclosure requirements to many companies incorporated outside the EU. Companies will need to detail both their impacts on the environment and the climate-related risks they face.

Some companies will have the option to report for just their EU businesses, but some will be required to make enterprise-wide disclosures. Even those that are not required to provide global information will have to decide whether to do so for consistency.

In March 2022, the U.S. Securities and Exchange Commission proposed climate-related disclosure rules, and in April 2022 the United Kingdom introduced new legislation requiring disclosure of this kind of information. It is not yet clear how much the requirements will differ between jurisdictions, or whether the EU will accept disclosures that meet the standards set by the U.S., U.K. or other countries.

EU companies that are already subject to EU non-financial disclosure obligations will have to comply beginning in 2025 for the 2024 fiscal year. Large companies that will become subject to the rules for the first time, including non-EU companies, will need to disclose the information in 2026 for their 2025 fiscal years. Small and medium-sized enterprises will have another year.

More companies are affected. The law, the Corporate Sustainability Reporting Directive (CSRD) applies to many more companies than the 2014 EU law that currently governs non-financial disclosures. It will now apply to all EU-incorporated companies that satisfy two of the three "large company" criteria, as well as EU-incorporated parents where the corporate group collectively meets those. The criteria are:

- net turnover of more than €40 million;
- total balance sheet assets of more than €20 million; and/or
- more than 250 employees;

It is notable that these are rather low thresholds.

Companies incorporated outside the EU may be subject to the law if they have net annual turnover in the EU of more than €150 million in two consecutive financial years and have at least one EU subsidiary that meets two of the three large company requirements above, or an EU branch has a net turnover of more than €40 million.

Management teams and boards will need to consider whether they will be required to report enterprise-wide or jurisdiction by jurisdiction.

The law imposes "double materiality" obligations. Under the new law, a company will need to include information necessary to understand both (a) the company's impacts on sustainability matters and (b) how sustainability matters affect the company's own development, performance and position. That will include information about the company's own operations and its value chain.

The European Commission acknowledges that it may be difficult to gather this data, so for the first three years, the law will be applied on a "comply or explain" basis: Where a company cannot provide the information, it should explain the efforts it has made to obtain the information and why it could not be provided.

"Limited" assurance audits will be required. Sustainability information must be checked by third parties. These "audits" will be less extensive than those for financial statements, but the European Commission has not yet adopted detailed standards. It expects to do so by October 1, 2026. In the meantime, companies will need to consider the standards and procedures of the member states in which they are incorporated when arranging their audits.

The reporting standards are still being developed. In November 2022, the private European Financial Reporting Advisory Group submitted 12 draft sustainability reporting standards under the new law, and the European Commission plans to finalize requirements by June 2023. At present, there is limited information about the proposed standards, but the picture should become clearer later in the year.

Exemptions remain for global corporations. An entity will be exempt from the reporting requirements at an individual level if the consolidated management report of its parent company includes the results of the company and its subsidiaries. The exemption will be available if a group's consolidated management report is in a form considered equivalent to EU standards, based on an equivalency mechanism that will be outlined by the EU at a future date.

Will there be a divergence or convergence in sustainability disclosures? It is unclear whether the U.S. Securities and Exchange's proposed climate disclosure requirements or parallel U.K. rules will be considered equivalent. If the EU does not accept compliance with the U.S. or U.K. regimes, companies will need to consider how best to meet the competing jurisdictional demands. That will entail weighing the risks of providing different levels of detail for subsidiaries in different countries or choosing to report according to one regime for all subsidiaries and affiliates with particular supplemental information as required.

The immediate task for companies is to gear up for the new mandates. While the EU formulates more detailed rules and other jurisdictions frame their own environmental disclosure standards, multinationals need to begin preparing for the new demands, which may involve adding resources.

Management teams and boards will also need to consider whether they will be required to report enterprise-wide or jurisdiction by jurisdiction, and, if the latter is an option, whether that is the best approach.

Authors
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A Board Chair Explains How To Make the Most of Self-Evaluations

Interview With Dona D. Young, Non-Executive Chair of Foot Locker, Inc.

Q: How do board self-evaluations contribute to building stronger boards of directors?

A: A company's board of directors should be viewed as a strategic asset. One part of ensuring that the board can add value relates to board composition. Once you get that right, the second critical element is working to ensure that the board continues to grow and is being optimized. Boards expect management teams to evidence accountability for their actions, evaluate outcomes and implement improvements. If we require that of management, then as directors we should model those same behaviors and engage in self-reflection and self-improvement.

There are three levels of a thorough self-evaluation — the board, the committees and individual director "360" evaluations. An independent board leader, whether that is a non-executive chair, a lead independent director or a nominating and governance committee chair, plays an important role in a good self-evaluation process.

There are a variety of approaches to self-evaluation at the board level. Written questionnaires are common, but probably work best when they are combined with one-on-one calls with each director and the lead independent director or independent chair (or nominating and governance committee chair). Those conversations can provide more color and nuance than the written responses alone. Of course, confidentiality is critical. And the board leader conducting those interviews should be subject to a similar feedback process, which can be the subject of one-on-one calls with another independent director.

The real acid test of an effective board self-evaluation process is the output. If a board is trying to improve, the board self-evaluation process should result in an action plan to enhance the functioning of the board. That plan does not need to be dramatic; it might just be two or three small items. And at some point there should be a report to the board on that action plan and the outcomes – what changes were actually made in response to the feedback and were those changes effective.

Similarly, committee evaluations can take a variety of forms and written questionnaires are common. Again, combining those with one-on-one calls can add significant insights and feedback. Those calls can be conducted by each committee chair or by the non-executive chair/lead independent director.

Individual director evaluations are gaining traction. They can elevate the contributions of individual directors and thereby improve the effectiveness of the entire board. Generally, if these individual evaluations are done, they are conducted every two-to-three years and utilize an outside facilitator. Although the outside facilitator can be useful in collecting the feedback and protecting directors' confidentiality, the feedback messages to individual directors should be delivered by the independent board leader coordinating the process. Again, the utmost confidentiality is required.

At boards that have not yet done these 360 reviews, there may be a concern among some directors that these are a tool to get rid of underperforming directors. These reviews work best when they are understood as a method of realizing the full potential of every director rather than as a method of remediating any undesirable behaviors, which are best addressed by a board leader on a regular basis, as needed. For those boards, the advice is to keep discussing and socializing the idea of 360 reviews with directors, reinforce the principle that these reviews are about making the board better and continue to build up the trust among directors that is necessary to eventually move forward on this path.

Like feedback systems in any other context, board self-evaluations and director reviews require trust and safe spaces to truly reflect in an honest way on areas for improvement. It is incumbent on board leadership to help build that boardroom culture of trust and self-reflection — which means for the board leader, not just being open to receiving feedback from fellow directors, but herself modeling the behavior of self-improvement by incorporating that feedback. Board self-evaluation processes, including director 360 reviews, are about creating the kind of continuous and constructive feedback loops that help elevate the performance of each director individually and, ultimately, contribute to building a stronger board as a whole.

Dona D. Young serves as the non-executive Chair of Foot Locker, Inc. and also serves on the supervisory board of Aegon N.V., and the boards of USAA, the National Association of Corporate Directors and Spahn & Rose Lumber Co. Ms. Young also serves on the boards of Save the Children International, Save the Children Association and Save the Children U.S. Ms. Young was Chief Executive Officer of The Phoenix Companies, Inc. from 2003 to 2009.

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