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CLIMATE

SEC Climate Disclosure Rules: Your Questions Answered

By Brian V. Breheny, Raquel Fox, Marc S. Gerber, Caroline S. Kim, Liz Malone, and Jeongu Gim

The Securities and Exchange Commission's (SEC) climate-related disclosure rules pose a host of issues for companies. Below are answers from Skadden's SEC Reporting and Compliance and Environmental Practice Groups to some of the questions submitted after our March 14, 2024, webinar, "The SEC's New Climate-Related Disclosure Rules: What Companies Need to Know."

Pending Legal Challenges

1. What is the outlook for the various legal challenges to the SEC's climate rules?

Challenges to the rules, which were filed in various circuits, have been consolidated in the US Court of Appeals for the Eighth Circuit. On April 4, 2024, while a request for a judicial stay to prevent the rules from taking effect was pending, the SEC voluntarily stayed the rules pending the outcome of judicial review.

Filer Status Impact on Implementation

2. What does the timeline look like for filers who change filer status during the implementation period? For example, a non-accelerated filer who becomes a large accelerated filer?

During the implementation period, the issuer's filer status as of the beginning of the fiscal year generally would determine the applicable rules for that year's annual report. So, for example, a non-accelerated filer with a December 31 fiscal year-end that becomes a large accelerated filer as of January 1, 2026 would need to comply with all requirements of the new rules other than those relating to third-party assurance for Greenhouse Gas (GHG) emissions disclosure, for the issuer's annual report for fiscal year 2026. Conversely, an accelerated filer with a December 31 fiscal year-end that becomes a non-accelerated filer as of January 1, 2026 would not need to comply with the new rules for its annual report for fiscal year 2026.

One potential exception is for issuers that newly qualify as smaller reporting companies (SRCs) in the middle of a fiscal year based on their public float as of the end of the second quarter. Those issuers would follow the applicable phase-in periods and requirements for SRCs for their annual report for that fiscal year. In this regard, the adopting release notes that "[a] registrant will be exempt from any requirement to disclose its GHG emissions for any fiscal year in which it qualified as an SRC" and that "[a] registrant that previously qualified as an SRC also will be exempt from the GHG emissions disclosure requirements in the first fiscal year in which it no longer so qualifies."

Although filer status determinations are made as of the end of each fiscal year (other than for SRCs, as noted above), those determinations are based on issuers' public float on the last business day of the most recently completed second fiscal quarter, which should provide issuers an early notice of compliance obligations for the upcoming fiscal year.

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Defining Climate-Related Risks

3. Are all environmental risks now considered climate-related? For example, an energy supplier moving to renewables that started many years ago, not for climate-related reasons, but for clean air and water purposes. Is all of that now climate? What about water efficiency or moving away from single-use plastics? That used to be recycling. Is that now a climate-related risk?

No, not necessarily. The definition of "climate-related risks" refers to the actual or potential negative impacts of climate-related conditions and events on a company's business, results of operations or financial condition. The SEC acknowledged that companies need time to develop, modify, and implement processes and controls necessary to assess whether something is a material climate-related risk. Although much of the discussion has focused on materiality judgments, companies also will need to assess the relevant facts and circumstances to make a judgment as to whether something is climate-related.

Board Committee Oversight

4. If the charter of a board committee (for example, nominating/governance committee) explicitly assigns that committee oversight of "sustainability strategies" and "environmental matters relevant to the company's business" but not specifically "climate risk," do we still need to describe board oversight? Can we avail ourself to the materiality carve-out if there is no significant climate change risk/impact?

The requirement under the rules is to describe board (or board committee) oversight of climate-related risks (or climate-related targets or goals), regardless of whether such oversight is memorialized in a committee charter. A committee charter that references oversight of sustainability or environmental matters might create the impression that the committee's oversight includes climate-related risks, but that is not necessarily the case.

Importantly, the SEC stated in the adopting release that disclosure is not required in the event that the board (or a board committee) does not exercise oversight of climate-related risks. Note, however, that the SEC explicitly declined to adopt a materiality qualifier with respect to board oversight of climate-related risks.

Materiality Determinations

5. Do we have to disclose the process by which we determine whether climate-related risks are material to our business?

No, not necessarily. While new Regulation S-K Item 1501(b) requires disclosure of management's role in assessing and managing the company's material climate-related risks, including, among other things, "[t]he process by which [management] positions or committees assess and manage climate-related risks," those process may be separate from the company's process for analyzing the materiality of climate-related risks. Note that this requirement is similar to the risk management and strategy disclosure requirement under Regulation S-K Item 106(b) relating to cybersecurity.

6. Current rules require companies to disclose all material information in any event, so does adding the new climate-related disclosures lay the groundwork for plaintiffs to argue that the company should already have been disclosing the information?

Facts and circumstances continue to evolve, so that a risk that was judged not to be material in the past could at some later point be deemed material. There is always a risk that prior materiality judgments will be second-guessed with the benefit of hindsight.

7. In connection with risk mitigation, would it be easier for some companies to support a "not material" determination than to defend against "false and misleading" claims by plaintiffs based on climate-related disclosures?

Of course, these materiality judgments always depend on a company's unique facts

and circumstances. Presumably, plaintiffs could allege that the absence of climate-related disclosure constitutes a material omission as easily as they could allege that climate-related disclosures included in an annual report are materially false and misleading.

GHG Emissions Disclosures

8. Can you confirm that we do not need to disclose Scope 1 and Scope 2 GHG emissions by segment?

Yes. The final rules do not specifically require a breakdown of Scope 1 and Scope 2 GHG emissions by segment.

9. Do you need to actually measure Scope 1 and 2 to determine materiality, or can you make a qualitative determination?

Not necessarily. While it will depend on specific factors for each reporting company, we believe there are ways to make a materiality determination without actually calculating emissions. For example, the Sustainability Accounting Standard Board (SASB) has identified a number of sustainability topics by industry that its research has suggested are most likely to be useful to investors. For certain industries, the SASB standards include GHG emissions as a material topic, but not for all industries.

Likewise, if management reasonably determines that it is unlikely that the reporting company will be subject to any climate-related transition or regulatory impacts and the company has not set any material goals related to emission reductions, then, absent any company-specific factors, we believe that would be sufficient to conclude that the company's Scope 1 and Scope 2 emissions are not material.

However, as noted during our webinar, even if the emissions do not need to be disclosed under the SEC rules, they may be subject to disclosure requirements in other jurisdictions such as California and the European Union.

10. If Scope 3 GHG emissions are part of a transition plan to manage a material transition risk or a material climate-related target or goal, do they need to be disclosed?

Scope 3 GHG emissions data is not required by Regulation S-K Item 1505 and does not need to be disclosed, even if Scope 3 GHG emissions are relevant to a transition plan or climate-related target or goal under the final rules.[1]

Qualitative discussion of Scope 3, however, may be required in describing a transition plan pursuant to Regulation S-K Item 1502(e) or to provide the "additional information or explanation necessary to an understanding of the material impact or reasonably likely material impact of the [disclosed material climate-related] target or goal" pursuant to Regulation S-K Item 1504(b). In particular, qualitative discussion of Scope 3 may be required to provide context in explaining a company's net zero target or any progress made toward meeting the disclosed climate-related target or goal pursuant to Regulation S-K Item 1504(c).

GHG Emissions Assurance

11. What disclosure is required if you already receive some sort of validation or limited assurance for your GHG emissions?

A registrant that voluntarily obtains assurance for GHG emissions will be required to provide certain disclosures, depending on filer status and timing relative to the phase-in periods. Voluntary assurance during the phase-in period will be subject to Regulation S-K Item 1506(e), which requires limited disclosures about the assurance provider, assurance standard used, level and scope of assurance services, the results of the assurance services, whether the assurance provider has any material business relationships with or has provided any material professional services to the registrant and information about any oversight inspection program applicable to the assurance provider.

	After the Compliance Date for GHG Emissions Disclosure but before the Compliance Date for Assurance	After the Compliance Date for Assurance
LAFs and AFs subject to Items 1505 and 1506(a) through 1506(d) (for example, registrants that are required to disclose GHG emissions and obtain assurance)	Any voluntary assurance over any GHG emissions disclosure must comply with the disclosure requirements in Item 1506(e).	Any voluntary assurance obtained over GHG emissions disclosures that are not required to be assured pursuant to Item 1506(a) (for example, voluntary Scope 3 disclosures) must follow the requirements of Items 1506(b) through 1506(d), including using the same attestation standard as the registrant's required assurance over Scope 1 and/or Scope 2 disclosure.
Registrants not subject to Items 1505 or 1506(a) through 1506(d) (for example, registrants that are not required to disclose GHG emissions)	Any voluntary assurance over any GHG emissions disclosure must comply with the disclosure requirements in Item 1506(e).	Any voluntary assurance over any GHG emissions disclosure must comply with the disclosure requirements in Item 1506(e).

Once Scope 1 and Scope 2 assurance becomes mandatory, a registrant that voluntarily discloses Scope 3 GHG emissions and also voluntarily obtains third-party assurance of such Scope 3 emissions would become subject to the full attestation report and disclosure requirements under Items 1506(b) through 1506(d).

The following summary chart is excerpted from pages 302-303 of the Commission's adopting release:

Financial Statement Disclosures

12. For purposes of the financial statement footnote disclosures, what amounts qualify to be disclosed? For instance, is it possible that market issues, such as interest rates or stock prices that are impacted by severe weather events, could trigger disclosures?

The disclosure requirements in new Regulation S-X, Article 14 (Disclosure of Severe Weather Events and Other Information) are focused on capitalized costs, expenditures expensed, charges, and losses incurred as a result of severe weather events and other natural conditions and capitalized costs, expenditures expensed, and losses related to carbon offsets and renewable energy credits (RECs).

These capitalized costs, expenditures expensed, charges, and losses represent quantitative information that is derived from transactions and amounts recorded in a company's books and records underlying the financial statements. These new disclosure requirements do not change the accounting for amounts companies record on their books. As a result, to trigger disclosures of market issues under the new rules, such as interest rates or stock prices, those issues would need to (i) have an accounting basis to be recorded in the company's books and records, (ii) be deemed to have resulted from severe weather events and (iii) be at amounts above the disclosure and de minimis thresholds provided in the new rules.

Note

1. *See* footnote 2494 of the SEC's adopting release ("All registrants subject to the final rules, including SRCs and EGCs, are not required to disclose GHG emissions metrics other than as required by Item 1505, including where GHG emissions are included as part of a transition plan, target or goal."). In recent remarks at an American Bar Association conference, Director of the SEC's Division of Corporation Finance, Erik Gerding, confirmed that Scope 3 GHG emissions data is strictly voluntary and therefore such quantitative disclosures are not necessarily required in the discussion of transition plans, targets or goals.

SHAREHOLDER PROPOSALS

What Is ExxonMobil Doing to Activists—and Why Does It Matter?

By Michael R. Levin

Most large publicly-traded corporations in the United States receive at least a few shareholder proposals for the annual general meeting each year. ExxonMobil shareholders voted on 13 of these in 2023, and evidently the company wanted to curtail this in future years. Its tactics worked, as it had only four at this year's annual shareholders meeting on May 29th (it had seven in 2022, still a high number relative to most companies). Those tactics merit explanation, and some comments about what they mean for all activists.

Earlier this year, ExxonMobil filed an actual lawsuit against two shareholders. Those proponents quickly backed off, and yet the company continued with the litigation. In its 2024 proxy statement, the company also explained in proud detail its approach to these and other shareholder proposals and proponents.

Two Proponents

ExxonMobil has of course been the subject of extensive activist attention over the years. Famously, one-time activist Engine No. 1 gained three board seats there in 2021 after a proxy contest centered on the company's climate initiatives. As a prominent oil and gas company, ExxonMobil sees its share of protest, complaint, and environmental, social, and governance (ESG) proposals each year. The proximate cause of this year's conflict was a proposal from two of the usual ESG shareholders.

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Those two, Arjuna Capital and Follow This, together submitted a climate proposal to ExxonMobil in December 2023. They've done that before at ExxonMobil, and at many other companies, it's what they do. At that point, almost all other companies ask the Securities Exchange Commission (SEC) to allow them to exclude the proposal from the proxy statement for the 2024 annual meeting.

One Lawsuit

ExxonMobil didn't like its chances with the SEC Staff, so it filed its lawsuit. Arjuna Capital and Follow This are tiny investors that can't possibly defend themselves in Federal district court in Texas. They withdrew their proposal within days, and remain defendants in this matter.

A portion of the complaint argues why ExxonMobil can exclude the proposal, based on its interpretation of the relevant SEC rules. The company essentially asks a Federal district court judge to ready and apply the relevant SEC regulations (Rule 14a-8). Most of it just goes after Arjuna Capital and Follow This, alleging the two "Work in Concert to Abuse the Shareholder Proposal Process at the Expense of ExxonMobil Shareholders," among many other assertions.

Three Pages

ExxonMobil didn't stop with the lawsuit. It devotes three dense, footnoted pages of the 2024 proxy statement (pgs 79-81) to a harsh critique of climate proponents and the SEC. It calls the proposals an "abuse of the system," with too many other insults to even begin to quote here. Read the whole thing.

Clearly, ExxonMobil has had it up to here with shareholder proposals. An unprecedented lawsuit against two immaterial shareholders and a harsh polemic in its proxy statement at least allows it to blow off the accumulated steam that dozens of shareholder proposals must generate. Yet, the implications go beyond allowing a privileged board to assert its dominance over those shareholders and also SEC Staff.

A New Direction

ExxonMobil extends an ongoing trend in a new direction. Companies increasingly litigate against shareholders over proxy contests, or compel shareholders to sue to enforce their rights, specifically on advance notice bylaw terms. Companies or their representatives periodically sue the SEC over one or another regulation. Now, a company has sued shareholder proponents, seeking to substitute the views of a Federal judge for those of SEC Staff.

Instead, ExxonMobil should consider letting this go. The proxy statement gripes about the cost and hassle of shareholder proposals. It claims $21 million in direct cost to respond to the 140 shareholder proposals it has received over 10 years.

Even if we accept the $150,000 per proposal cost from the SEC, a conservative estimate, the company spends about $2 million per year, completely immaterial to its billions in revenue and expenses, or even to the tens of millions it spends on board compensation and expense. It could take perhaps a handful of managers and staff to respond to a dozen proposals or so in a year.

How about just accepting the proposals it receives, dispensing with the SEC review process and of course lawsuits, and letting shareholders decide how to proceed?

SEC ENFORCEMENT

SEC Charges Now Suspended Auditor BF Borgers with Massive Fraud Affecting More Than 1,500 SEC Filings

By Eric Juergens, Morgan Hayes, Jonathan Tuttle, and Maeve O'Connor

On May 3, 2024, the Securities and Exchange Commission (SEC) announced settled enforcement proceedings against audit firm BF Borgers CPA PC and its owner, Benjamin F. Borgers (together, BF Borgers), charging them with deliberate and systemic failures to comply with Public Company Accounting Oversight Board (PCAOB) standards in its audits and reviews of hundreds of public companies, which were incorporated in more than 1,500 SEC filings from January 2021 through June 2023.[1]

SEC Order Against BF Borgers Imposes Severe Penalty

The SEC imposed severe penalties on BF Borgers, including a $12 million civil penalty against the firm and a $2 million civil penalty against its owner, as well as permanent suspensions against both parties from appearing and practicing as accountants before the agency, effective immediately. Gurbir S. Grewal, Director of the SEC's Division of Enforcement noted that "thanks to the painstaking work of the SEC Staff, Borgers and his sham audit mill have been permanently shut down."

The SEC found that BF Borgers failed to perform its audit and review engagements in accordance with PCAOB auditing standards, including by failing to adequately supervise the engagements, failing to obtain engagement quality reviews in connection with the engagements, failing to prepare and maintain sufficient audit documentation, and fabricating certain audit documentation, all while falsely representing to its clients and in its audit reports that the firm's work complied with PCAOB standards.

Specifically, the SEC found that at Benjamin Borgers's direction, BF Borgers' staff simply "rolled forward" workpapers from previous engagements, changing only the relevant dates, and passed them off as workpapers for current period engagements. These workpapers documented engagement planning meetings that did not occur and falsely represented that Benjamin Borgers and a separate engagement quality reviewer had reviewed and approved the work. Additionally, the SEC found that electronic "sign offs" on the firm's engagement workpapers that were attributed to the engagement partner, engagement quality reviewer, and staff auditor were in fact all applied by a single staff person within seconds of one another.

The SEC's order focused only on the firm's public company audit and review engagements and did not address the firm's work for private companies.[2]

Issuer Disclosure and Reporting Obligations in Light of SEC Order

The permanent suspension of BF Borgers no doubt throws its hundreds of audit clients into turmoil with respect to those clients' SEC filing obligations as they each search for a new firm. Acknowledging this, in a separate announcement, the SEC published

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guidance to assist impacted issuers in complying with their disclosure and reporting obligations.[3]

Each impacted registrant will first need to file an Item 4.01 Form 8-K when BF Borgers resigns or is dismissed. The Form 8-K must be filed within four (4) business days of the resignation or dismissal and requires the inclusion of information called for by Item 304 of Regulation S-K. As BF Borgers is suspended from appearing before the agency and therefore unable to agree to the Item 304 disclosures, the SEC is permitting affected registrants to instead indicate that their prior auditor is not currently permitted to appear or practice before the SEC.

Issuers that had engaged BF Borgers to audit or review financial information to be included in any Exchange Act filings to be made on or after May 3, 2024 will need to engage a new qualified, independent, PCAOB-registered public accountant. Given the Form 10-Q filing deadline for calendar year companies is fast approaching and the need for a new audit firm to review the interim financial statements, it is unlikely that BF Borgers's public company clients will be able to timely file their Forms 10-Q. The SEC reminded issuers of the availability of Exchange Act Rule 12b-25, which provides for a limited extension of the deadline for filing certain Exchange Act reports (15 calendar days in the case of Forms 10-K and 20-F and 5 calendar days in the case of Form 10-Q).

Issuers may file a Form 12b-25 no later than one business day after the original due date for the report and should include disclosure describing, in reasonable detail, the issuer's inability to file the report timely and the reasons therefore. Exchange Act reports that were filed before May 3, 2024 do not necessarily need to be amended solely because of the SEC's order, but issuers should consider whether their filings need to be amended to address any deficiencies that may exist as a result of their BF Borgers engagement, including as a result of any required restatement of previously filed financial statements.

Issuers that are currently in the registration process will need to file a pre-effective amendment with a new auditor before their registration statements can be declared effective. Similarly, issuers with a pending Regulation A offering statement will need to file a pre-qualification amendment with a new auditor. Any issuer who has submitted a draft registration statement for nonpublic review that contains an audit opinion from BF Borgers must retain a new auditor before publicly filing the affected registration statement. Given the time required for a new audit firm to complete the required audit work, this is likely to delay any such capital raise by months, not weeks.

In addition, since any sales of securities in transactions registered under the Securities Act must be preceded or accompanied by a Securities Act Section 10(a)-compliant prospectus, issuers who relied on an audit opinion from BF Borgers with effective registration statements will no longer be able to use impacted registration statements.

Litigation Preparedness for Issuers

Notably, the SEC order states that as a result of BF Borgers' conduct, certain of the firm's issuer and broker-dealer clients violated the reporting provisions of the Exchange Act by filing financial statements that had not been audited or reviewed by an independent public accountant in accordance with PCAOB standards. These particular reporting violations are actionable only by the SEC, which has not yet announced any charges against BF Borgers' clients in connection with the matter.

In addition, we expect the Plaintiffs' bar to explore creative ways to pursue private litigation against issuers that were impacted by this fraud. For example, BF Borgers' audit clients may face private litigation alleging that the clients violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) or Section 11 or Section 12 of the Securities Act of 1933 (Securities Act) by misstating that their financial statements were audited by BF Borgers in accordance with PCAOB standards.

Similar to any follow-on proceeding brought by the SEC, the likelihood of such private claims succeeding will depend in part on whether the plaintiff

can successfully allege that the clients knew or recklessly disregarded that the audit work performed by BF Borgers was deficient and whether in fact the new audit firm discovers material misstatements or omissions in financial statements audited by BF Borgers.

The SEC order does not indicate that there were any red flags that would have put BF Borgers' audit clients on notice of the firm's misconduct. In fact, to the contrary, the order notes that BF Borgers misled audit clients in its engagement letters by stating that the audits and quarterly reviews would be conducted in accordance with PCAOB standards. The only evidence that the order references relate to internal engagement team meetings and workpapers which would not ordinarily be available to audit clients. For example, the order mentions BF Borgers teams' failures to hold planning meetings at the beginning of engagements, workpapers that appeared to be copied over from prior periods, and details concerning the timing and circumstances of electronic workpaper sign offs in the BF Borgers audit management software.

On the other hand, Grewal's statement accompanying the order does refer to BF Borgers as a "sham audit mill," which at least suggests that the firm's misconduct extended to the substantive audit procedures performed on the engagements in question. As a result, it is possible that the SEC or private plaintiffs could pursue claims based on theories that the audit clients knew or recklessly disregarded BF Borgers' failure to conduct an audit in accordance with PCAOB standards.

The Plaintiffs' bar may also pursue theories that do not require proof of an issuer's *scienter*. Under Section 11 of the Securities Act, issuers are effectively subject to strict liability for material misstatements in connection with public offerings. Private litigants generally need not demonstrate causation or reliance on misstatements or omissions and could bring a damages suit under Section 11. It remains to be seen how the courts will assess claims against a public company that has been defrauded by its auditor.

Any private litigation against issuers may test the boundaries of a recent Second Circuit determination that shareholders failed to show that an auditor's false certification was *material* to investors. A three-judge Second Circuit panel ruled in August 2023 that shareholders failed to show that an auditor's allegedly false certification mattered to the issuer's investors, because the statements were so general that a reasonable investor would not depend on them. The same may be true concerning statements that BF Borgers conducted its audits in accordance with PCAOB standards, though the SEC would likely disagree: the agency submitted an *amicus* brief in support of a petition for rehearing in the Second Circuit, arguing that such auditor statements convey important information to investors, no matter their standardized form.

Other Considerations

The impact of this order may be felt beyond the above near-term considerations for affected public companies, including with respect to their contractual obligations with lenders.

Further, broker-dealers, investment advisers subject to the custody rule, and even private companies that engaged BF Borgers as their independent auditor will presumably need to find a replacement auditor and should give careful consideration when selecting a new firm.

Notes

1. *https://www.sec.gov/news/press-release/2024-51.*
2. *https://www.sec.gov/files/litigation/admin/2024/33-11283.pdf.*
3. *https://www.sec.gov/news/statement/staff-statement-borgers-05032024.*

STATE OF INCORPORATION

Delaware's Status as the Favored Corporate Home: Reflections and Considerations

By Amy Simmerman, Bill Chandler, David Berger, Joe Slights, Brad Sorrels, and Ryan Greecher

In recent months, a conversation has emerged as to whether Delaware should remain the favored state of incorporation for business entities. Indeed, many of our clients have asked us whether they should remain in Delaware or choose Delaware as the state of incorporation for their new ventures. In this discussion, we provide our reflections on that question and various factors that entrepreneurs, investors, and companies should consider when weighing incorporation in Delaware against incorporation in another state.

The Reliance on Delaware Compared to Other States

The sheer number of entities formed in Delaware reflects its dominance in this area. In 2022, more than 313,650 entities were formed in the state of Delaware, resulting in more than 1.9 million entities total in Delaware.[1] Delaware also continues to be the state of incorporation for nearly 68.2 percent of the Fortune 500, 65 percent of the S&P 500,[2] and approximately 79 percent of all US initial public offerings in calendar-year 2022.[3] Of course, those numbers reflect that a substantial portion of entities are incorporated elsewhere, both within and outside of the United States. The Chief Justice of Delaware's Supreme Court has noted that business entities indirectly or directly generate about a third of the state's revenue.[4]

It also bears noting that Delaware has not always held the distinction as the favored destination for incorporations. Prior to the early 1900s, New Jersey had been the most significant state for incorporations.[5] Aware of New Jersey's early success and in an effort to encourage corporations to domicile in Delaware, Delaware amended its constitution in 1897 to permit incorporation under general law instead of by special legislative mandate, and in 1899 adopted a general corporation law modeled largely after New Jersey's approach.[6] These developments, in addition to the written opinions issued by Delaware's Court of Chancery, helped make Delaware a natural home for corporations looking to leave New Jersey after that state adopted more restrictive laws related to corporations and trusts in 1913.[7]

A corporation's state of incorporation is significant because that state's laws govern the corporation's internal corporate governance and inform how judges will review the conduct of directors and officers in stockholder litigation. As will be discussed in greater detail below, there are a number of factors that have made Delaware a favored state of incorporation for over a century.[8]

Why Is Delaware in Question?

Of course, it is critical to understand why some have called Delaware's dominance into question. Some of the doubt has come from famous sources, such as Elon Musk's much-publicized X (formerly Twitter) post stating, "Never incorporate your company in the state of Delaware" after the Delaware Court of Chancery rescinded his compensation

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Au: This date has already passed. Do you want to update?

package at Tesla.[9] Tesla's stockholders are now expected to vote on the conversion of Tesla from a Delaware corporation to a Texas corporation at the company's annual stockholder meeting on June 13, 2024.[10] In the conversations that we have had with clients, businesspeople, and others in the corporate bar, we have heard the following reasons given for reconsidering incorporation in Delaware:

- A growing number of cases that have addressed technical issues, in the M&A context and elsewhere, and reached unexpected results in a manner that has impacted corporate structuring and transaction planning.
- A perception that Delaware judges have in several opinions adopted an increasingly suspicious or negative tone toward corporate boards and management, and toward the corporate bar.
- The challenges that the case law can pose for companies with influential founders or significant stockholders, the process mechanisms that such companies are expected to use, and the remedies that have been reached in those cases.
- A sense that Delaware judges can be skeptical of the governance of venture-backed private companies and many Silicon Valley-based companies.
- The increasingly active, and successful, plaintiffs' bar in both technical and fiduciary claims, which can leave boards and management with the sense that they are planning around "gotcha" litigation driven by plaintiffs' lawyers more than those lawyers' individual clients.

Many of these considerations are relevant for companies of all kinds, as they undertake transactions of all sorts. As to companies with significant stockholders in particular, they frequently grapple with the framework Delaware law has set forth: Transactions resulting in any arguable special benefit to the controller trigger the difficult entire fairness standard of review in stockholder litigation, unless the parties properly condition the transaction on approval by an independent board committee (which must be entirely independent) and minority stockholders.[11]

This framework can feel untenable in many situations—particularly outside of the context of a sale of the company—given: (1) the uncertainty that can exist in assessing board independence in some scenarios, along with the frequent occurrence that the independence of excellent board members is a close judgment call; and (2) the execution risk involved in seeking supermajority stockholder votes for all sorts of transactions. Boards of companies with large stockholders, as all boards, want to be able to guide the best interests of the company and stockholders using their fiduciary judgment, without jeopardizing their decisions. That desire is consistent with Delaware's board-centric model.[12]

In addition, at the time of this publication, amendments to the Delaware General Corporation Law (DGCL) are under review in Delaware that would, among other things, address some of the technical issues flowing from recent case law and provide greater stability in M&A practice.[13] Given the consequence of the amendments, many are monitoring the outcome of those legislative efforts and the manner in which they are handled.

Crediting the best motives behind the concerns that have been expressed, those concerns emanate from a desire for stability, balance, and an environment that allows for the productive carrying out of corporate affairs—qualities, as we discuss below, for which Delaware has historically been known.

This also is not the first time that Delaware's position has been questioned. For example, in the 1980s, a serious debate emerged about the ongoing favorability of Delaware.[14] Historical perspective is always valuable. But the current conversation is, in our experience and based on markers in the market,[15] serious.

Why Delaware Has Maintained Dominance

In assessing the ongoing utility of Delaware corporate law, it is important to understand what has historically given rise to Delaware's prominence and what will undoubtedly keep Delaware in use

for many business entities for years to come. The reasons for Delaware's prominence are multi-faceted and interrelated.

Talented, Responsive, and Knowledgeable Judiciary

A key reason for Delaware's success is the core belief that corporate governance and business disputes will be heard by smart, unbiased, responsive, and thoughtful judges. These courts have decades of experience and a long track record of handling (often in very expedited fashion) sophisticated business disputes. Business disputes in Delaware are mostly heard and decided by the Delaware Court of Chancery (the trial court) and the Delaware Supreme Court (the appellate court). The Court of Chancery, the primary business court, is modeled and named after the traditional equity court of England and currently consists of seven judges, increased from five judges in 2018 to handle the court's ever-growing workload.

There are no juries or punitive damages. The Delaware Superior Court is the other trial court in Delaware, with jurisdiction over business disputes that do not come within the ambit of the Court of Chancery, for example, many types of contract disputes involving claims for money damages. The five judges who serve on the Complex Commercial Litigation Division of the Delaware Superior Court are experienced and routinely decide business disputes quickly, and parties can elect to proceed without a jury trial.[16]

The judges come from Delaware's generally respected and sophisticated bar and often its corporate bar. As a result, the judges generally are well versed or expert in corporate law from the moment they take the bench. In contrast to the approach of many other jurisdictions, Delaware judges are not elected and are instead appointed and vetted through a careful process: candidates apply to become judges; candidates are screened by Delaware's Judicial Nominating Commission, which consists of Delaware lawyers and officials and makes recommendations to the Delaware governor; Delaware's governors are known for carefully evaluating and selecting judges; and any judicial nominee selected by the governor must be confirmed by the Delaware Senate. Delaware's judges serve 12-year terms.

The Delaware courts also act quickly. The Court of Chancery regularly hears fast-moving disputes with timing exigencies within weeks or months.[17] For example, in late 2023, the Delaware Court of Chancery issued a decision over the holidays in a proxy contest as a stockholder meeting loomed.[18] There is a direct right of appeal from the trial courts to the Delaware Supreme Court and, in certain circumstances, appeals can be heard on an expedited basis in a matter of weeks or even days.[19] Even in less exigent cases, the Delaware courts often hear cases in months rather than years. This speed is valuable for companies facing pressing circumstances and ever-evolving business considerations.[20]

Up-to-Date and Carefully Considered Statute

The DGCL—the corporate statute in Delaware—provides the backbone of the rules that govern Delaware corporations and is carefully reviewed each year for necessary or advisable updates. The Corporation Law Council of the Delaware State Bar Association, which consists of corporate lawyers in Delaware, recommends amendments to the DGCL based on developments in practice and the case law.[21] These amendments must then be adopted by the Delaware legislature and signed into law by the Delaware governor.

In recent years, for example, the DGCL was updated, based on observed trends and difficulties encountered by Delaware corporations, to allow companies to adopt additional protections for officers and to allow companies to more easily undertake reverse stock splits. With fairly limited exceptions over time, the legislative process in Delaware is handled in an apoliticized and moderate manner, with the central aim being the maintenance of the high quality of the DGCL. Indeed, at the time of this publication, amendments to the DGCL are under review that would, among other things, address some

of the technical issues flowing from recent case law and provide greater stability in M&A practice.[22]

Developed Case Law

The DGCL is an important feature of Delaware corporate law, but much of the richness of Delaware corporate law comes from Delaware's judge-made case law. The case law fleshes out the DGCL where interpretation is necessary, and the case law is often *the* law in areas where the statute does not address an issue, such as the fiduciary duties of directors and officers and the interpretation of merger agreements.

The Delaware courts have busy dockets and decide hundreds of corporate cases each year. That case law, resulting in thousands of cases over time—built up from the early 1900s forward—provides guidance to corporate actors in an array of situations. It is often the case that when a company has a question about how a dispute or issue would play out, some case law exists that provides insight into or color on the question. No state comes close to Delaware in the depth and breadth of corporate case law, and Delaware cases are routinely cited by courts in every state. Of course, this puts a premium on the case law developing in a stable manner over time.

Nimble and User-Friendly Secretary of State's Office

Corporate entities must make an array of filings with their state of incorporation in order to maintain their corporate form and effect various types of transactions. Delaware's Division of Corporations of the Delaware Secretary of State processes corporate filings, such as certificates of incorporation, charter amendments, certificates of merger, and franchise tax documents, quickly and effectively.

This is important when businesses seek, for example, to form corporate entities or to file certificates effecting mergers or initial public offerings on a fast or carefully timed basis. For many types of filings, the Division of Corporations can "pre-clear" filings by reviewing them in advance to ensure that they will be accepted for filing, and corporations can pay to have many of their filings reviewed and accepted in as little time as 30 minutes. Unlike certain other states, Delaware reviews most filings only for the form of the filing and does not conduct substantive review, which allows filings to be processed quickly. We are aware of reports from other states of routine delays—ranging from days to months—for the processing of routine corporate filings. Although the issue of filings can seem mechanical, this speed and efficiency allow transactions to happen with precision and certainty and may not be available in every state.

Delaware Law's Flexibility

As to structuring companies and transactions, Delaware law has historically afforded significant flexibility to market actors. The Delaware case law typically has embraced the concept of private ordering, that is, allowing companies and investors to use the DGCL as a broad enabling statute to structure entities and transactions creatively.[23] The case law and market are replete with examples of making use of this flexibility. For example, in 2023, the Court of Chancery upheld a particular form of dual-class structure permitting holders of the same class to have different amounts of votes for their shares depending on the identity of the stockholders (founders and other large stockholders as compared to public stockholders generally).[24]

In recent years, the Delaware courts upheld the use of forum selection provisions in charters and bylaws to address costly trends in stockholder litigation.[25] Limited liability companies and partnerships can be structured on an almost entirely customized basis and are creatures of contract. In 2013, Delaware introduced the Delaware public benefit corporation (PBC), allowing corporations to be managed in a way that balances stockholder pecuniary interests, a specified public benefit purpose, and stakeholder interests—and now approximately 20 publicly traded PBCs and thousands of private PBCs exist.[26]

Most recently, artificial intelligence companies have used Delaware law to innovate in their corporate structures in an effort to build guardrails and safeguards around their business.[27] In prior circumstances where Delaware law has been perceived as

affording less flexibility than is desired, the DGCL has been amended to address such concern.[28]

Delaware's Sophisticated Bar and Delaware Law As a Known Currency

As Delaware has established its significance in corporate law over time, it has followed that Delaware has a large and established corporate bar available to provide sophisticated Delaware law advice and represent corporate actors in complex business disputes. Similarly, lawyers all over the country and the world are familiar and facile with Delaware law, which has in turn become the *lingua franca* of corporate governance and transaction planning.[29]

Consideration of Other States

For companies, entrepreneurs, and investors considering incorporation in other states, it is important to understand the substance of the corporate law in those states and the landscape of their courts. Below we summarize such considerations for two states—Nevada and Texas—that have received more attention of late, as well as California, where many companies are headquartered. Other states, such as New York, which has an established corporate bar and court system, also may be deserving of consideration. The below discussion is of course not exhaustive, but is designed to provide some sense of the differences that may exist across states that are most frequently mentioned as alternatives to Delaware.

Nevada

Substantive Law

The Nevada legislature has signaled its intent to distinguish Nevada corporate law from Delaware law in certain substantive ways.[30] For example, unlike Delaware corporate law, where fiduciary duties are a matter of common law and developed through case law, the fiduciary duties of directors and officers of a Nevada corporation are codified in the Nevada Revised Statutes (NRS) and require that directors and officers "exercise their respective powers in good faith and with a view to the interests of the corporation."[31]

In contrast to Delaware corporate law, the NRS provides that a director or officer will only be liable to the corporation or its stockholders or creditors in limited circumstances where: (1) the presumption of the statutory business judgment rule has been rebutted; and (2) such director or officer's conduct constitutes a breach of such person's fiduciary duties involving intentional misconduct, fraud, or a knowing violation of law.[32] Notably, the Nevada Supreme Court recently clarified that Nevada law does not recognize an "inherent fairness standard" with respect to its review of directors' and officers' liability under the NRS,[33] which differs from Delaware law's use of the exacting entire fairness standard where, for example, a controlling stockholder gains a special benefit in a transaction or half or more of the board has a conflict and the corporation does not use certain process mechanisms.

The NRS indicates that there is not to be a heightened standard of review of a change of control (in contrast to the *Revlon* doctrine in Delaware) unless the directors or officers take action to resist a change in control which impedes the right of stockholders to vote for or remove directors.[34] These differences appear to be a deliberate departure from Delaware's standards,[35] and recent case law and statutory amendments confirm that the Nevada statute is the "sole avenue" to hold directors and officers liable for breach of their fiduciary duties. In the views of some, this indicates an express attempt to discourage Nevada courts' consideration of Delaware law.[36]

Another big-picture difference between the corporate law of Nevada and Delaware arises with respect to the purpose of a corporation and the interests that the board of directors may consider when making certain decisions. Unlike for a traditional Delaware corporation, where the ultimate purpose of fiduciary duties is to advance stockholder value,[37] the Nevada legislature adopted a constituency statute specifically broadening the interests that directors and officers may consider.[38]

Under Nevada law, directors and officers may consider all relevant facts, circumstances, contingencies, or constituencies, including the interests of all stakeholders affected by the corporation.[39] Additionally, directors and officers are not required to consider, as a dominant factor, the effect of a proposed corporate action upon any particular group or constituency having an interest in the corporation (that is, stockholders).[40]

A further difference arises with respect to stockholder books and records inspection rights. Under the NRS, these rights are limited for the stockholders of private Nevada corporations to those owning not less than 15 percent of the outstanding shares of stock; there is no minimum ownership requirement under the DGCL.[41]

Courts

In 2000, the Nevada Supreme Court established business courts in Nevada's Second and Eighth Judicial District Courts as part of Nevada's efforts to become a "Delaware of the West."[42] The Nevada business courts have broader jurisdictions than Delaware's Court of Chancery, and each judicial district may have its own rules governing its business court.[43] Additionally, unlike Delaware, all judges, including those serving on the business courts, are elected in Nevada, rather than appointed by the governor.[44] It also appears that certain matters may be heard by juries in Nevada business courts.[45] Legislative sessions in Nevada are held every other year in odd-numbered years (rather than annually like Delaware), providing for a less frequent opportunity to amend the NRS to account for developments in practice or the market.[46]

Texas

Substantive Law

Texas corporate law has relevant substantive differences from Delaware corporate law, while maintaining certain fundamental similarities (although, to be sure, the Texas case law is much less developed).[47] For instance, and substantively similar to Delaware, directors and officers owe the fiduciary duties of obedience, loyalty, and due care in performing their duties.[48] Practitioners have noted that, although the relevant case law is less established than in Delaware, officers also owe fiduciary duties under Texas law.[49] As in Delaware, Texas courts have adopted a form of the business judgment rule, which will protect directors and officers from being held liable for alleged breaches of duties in certain circumstances.[50] Also, similar to Delaware, a Texas corporation's charter may contain an exculpatory provision eliminating or limiting a "governing person's"[51] personal liability, subject to certain exceptions.[52]

An area where the contours of the corporate laws of Texas and Delaware seem to differ is with respect to the fiduciary duties owed by controlling shareholders. For example, Texas case law suggests that controlling shareholders, even in a closely held corporation, do not owe formal fiduciary duties to their fellow shareholders.[53] However, Texas courts have recognized that a relationship between particular shareholders may constitute a "confidential relationship," which may give rise to informal fiduciary duties when influence and confidence in such shareholder has been justifiably created.[54] Additionally, a few Texas cases have alluded to a controlling shareholder owing fiduciary duties to the corporation.[55] Of course, this contrasts with Delaware, where the Delaware courts have issued hundreds of decisions providing guidance on controlling stockholder matters.

Texas corporate law also differs in some respects from Delaware law with regard to its articulation of corporate purpose. For example, the Texas Business Organizations Code (TBOC) specifically codifies the interests that directors are entitled to consider when discharging their duties as directors—and they are broader than under Delaware law.[56] Officers are entitled to consider these statutorily defined interests, subject to direction by the board of directors.[57] In addition, directors and officers may consider any "social purposes" specified in the corporation's certificate of formation.[58] Moreover, even if a corporation's certificate of formation does not include a

social purpose, the TBOC provides that this section does not limit a director or officer from taking an action that promotes or has the effect of promoting a social, charitable, or environmental purpose.[59]

Additionally, shareholders of Texas corporations have greater limitations on their ability to demand inspection of corporate books and records than do stockholders of Delaware corporations. Under the TBOC, only shareholders who have held shares for at least six months or who hold at least 5 percent of all outstanding shares may make a demand for inspection.[60] Texas law also provides appraisal rights to stockholders, which can be costly, in more types of transactions than Delaware does.[61]

Courts

In June 2023, the Texas legislature passed a law establishing business courts in Texas, and such courts will be operational as of September 1, 2024.[62] While Texas judges generally are elected,[63] the judges of the business courts will be appointed by the governor with the consent of the Texas Senate.[64] Practitioners have suggested that this arrangement may be subject to challenge under the Texas Constitution.[65] Texas has 11 judicial regions, and the business courts will first operate in five of these regions.[66] Juries will still be available in Texas business courts when required by the Texas Constitution.[67] Also, unlike Delaware, Texas has limits on fees for attorneys litigating class actions.[68] Like Nevada, the Texas legislature holds legislative sessions every other year in odd-numbered years, rather than annually.[69]

California

Substantive Law

California corporate law is substantively similar to Delaware corporate law in many aspects (although the California case law is much less developed). As Delaware, for example, directors and officers owe fiduciary duties to the corporation and its shareholders in performing their duties.[70] In addition, California courts have found that majority shareholders owe fiduciary duties to minority shareholders.[71] Also, as in Delaware, California courts have adopted a form of the business judgment rule that provides that the courts will defer to the decisionmaking of directors in the absence of fraud or breach of trust, and so long as no conflict of interest exists.[72] Further, the articles of incorporation of a California corporation can include an exculpatory provision eliminating or limiting a director's personal liability, subject to certain exceptions.[73]

Despite these big-picture similarities, however, certain technical requirements of the California Corporations Code (CCC) fundamentally differ from the analogous provisions in the DGCL, which could lead to potential "foot faults" for companies more familiar with Delaware's technical requirements. Many of these differences relate to the constitution and operation of a company's board of directors. For example, the CCC has varying requirements relating to the number of directors that must serve on a board based on the number of shareholders of the corporation, if any, and sets forth certain approval requirements for reducing the board size in some instances.[74]

Other differences include that the board can effectively remove a director if the director is declared to be of unsound mind by an order of court;[75] a board of directors may have staggered terms only if the company is listed on a requisite stock exchange;[76] a director's term may be effectively shortened by effectuating a "voting shift";[77] and compensation for service on a board or a committee cannot be decided by a committee of the board.[78]

Further, in contrast to the Delaware Secretary of State, the California Secretary of State plays a more substantive role in reviewing corporate filings.[79] Specifically, if the California Secretary of State determines that an instrument submitted for filing does not conform to law, the instrument may only be resubmitted if it is accompanied by a written opinion of a member of the California bar that the specific provision of the instrument objected to by the California Secretary of State does conform to law.[80]

Courts. California does not have business courts, but instead utilizes complex civil litigation dockets.

The jurisdiction of these dockets is broader than that of Delaware's Court of Chancery, and juries may be utilized.[81] Judges are elected at all levels of the California judiciary; however, judicial candidates for appellate courts and the state's Supreme Court must first be nominated by the governor and confirmed by the Commission on Judicial Appointments. California has a full-time legislature that meets throughout the year.[82]

Franchise Taxes

Another common topic of conversation related to a corporation's state of incorporation is franchise taxes. In Delaware, franchise taxes can be calculated based on an authorized share method or an assumed par value method.[83] The maximum annual franchise tax in Delaware is $200,000, unless a corporation qualifies as a "large corporate filer," in which case the maximum annual franchise tax is $250,000.[84] Nevada does not impose any franchise taxes on corporations.[85] Texas imposes franchise taxes as a percentage of a corporation's taxable margin.[86] California imposes franchise taxes based on a percentage of a corporation's income.[87]

Where Does This Leave Companies Today?

What are companies, entrepreneurs, and investors to make of these considerations? In our view, corporate actors must understand and assess the trends that have led to this debate. Even if a given company wishes to avoid or leave behind the trends in Delaware that have given some market actors pause, the company should carefully consider relevant counterpoints.

- The company should understand the substantive law of another state under consideration, at least as to its material contours, including how a given body of law approaches the purpose of the corporation and the fiduciary duties and accountability of the board and management.
- The company should consider whether any case law exists to give guidance on the future needs of the company; that statutes and case law may differ in meaningful ways from Delaware; and whether the company will find it acceptable to be told that the answer may be less clear in another state or that the answer will be more expensive to obtain because of the lack of guidance. Questions that a lawyer may be able to answer under Delaware law in 15 minutes may take significant exploration and research in another state—and even then, may yield an unclear answer, or no answer at all. Of course, some of the recent unpredictability in the Delaware case law impacts this analysis.
- The company should consider the court system of other states—for example, whether judges less familiar with corporate law may decide a dispute; whether a jury proceeding, along with the different dynamics that brings, is a risk; and whether the courts will move as quickly as they do in Delaware. Additionally, there are potentially meaningful fiduciary duty and litigation considerations with moving a company out of Delaware, as evidenced by recent litigation in Delaware that will now go to the Delaware Supreme Court.[88]
- Finally, it is important to keep in mind the other efficiencies involved in using Delaware law, such as the relative ease of making corporate filings in Delaware and the familiarity that transactional lawyers and investors have with Delaware law, all of which can facilitate the speed and accomplishment of transactions.

There are many reasons why, in our view, Delaware is likely to remain in use for some time, and we have attempted to outline several of them here. That said, we have seen a growing number of corporate actors evidence some willingness to explore giving a different state a try and a real debate emerge over these issues. We recognize and understand that debate, while also recognizing the ongoing vibrancy and substantial benefits of Delaware law, its judiciary, and its corporate infrastructure. As this debate continues,

corporate boards must consider these issues in the same way they consider all issues that go to the core business judgment of directors, and other corporate actors must consider the full dimensions of these issues as well.

Notes

1. *Delaware Division of Corporations: 2022 Annual Report*, Del. Div. of Corps. (2022), *https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2022-Annual-Report.pdf* [hereinafter the *DE 2022 Annual Report*].
2. By way of comparison, while 325 S&P 500 companies are incorporated in Delaware, four are incorporated in California, four are incorporated in Texas, and three are incorporated in Nevada. *See Capital IQ Company Screening Report, S&P 500* (Apr. 15, 2024).
3. *DE 2022 Annual Report*, *supra* n.1.
4. Sarah Petrowich, "Judicial Branch Requests Funding for New Positions to Decrease Judicial Officer Case Load," Del. Pub. Media (Feb. 15, 2024), *https://www.delawarepublic.org/politics-government/2024-02-15/judicial-branch-requests-funding-for-new-positions-to-decrease-case-load-of-judicial-officers.*
5. *See* Samuel Arsht, "A History of Delaware Corporate Law," 1 Del. J. Corp. L. 1, (1976); Donald F. Parsons Jr. & Joseph R. Slights III, "The History of Delaware's Business Courts," 17-*APR Bus. L. Today* 21 (2008).
6. Arsht, *supra* n.5, at 6–7; "How Delaware Became No. 1," *NY Times* (May 9, 1976), *https://www.nytimes.com/1976/05/09/archives/how-delaware-became-no-1.html.*
7. Parsons & Slights, *supra* n.5.
8. Lewis S. Black Jr., "Why Corporations Choose Delaware," Del. Dept. of State (2007), *https://corpfiles.delaware.gov/pdfs/whycorporations_english.pdf.*
9. Tornetta v. Musk, 310 A.3d 430 (Del. Ch. 2024).
10. Tesla, Inc., Preliminary Proxy Statement for 2024 Annual Meeting of Stockholders (Schedule 14A) (Apr. 17, 2024), *https://www.sec.gov/ix?doc=/Archives/edgar/data/0001318605/000110465924048040/tm2326076d13_pre14a.htm.*
11. In re Match Grp., Inc. Derivative Litig., 2024 WL 1449815 (Del. Apr. 4, 2024).
12. W. Palm Beach Firefighters' Pension Fund v. Moelis & Co., 2024 WL 747180 (Del. Ch. Feb. 23, 2024); Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011); In re TW Services, Inc. S'holders Litig., 1989 WL 20290 (Del. Ch. Mar. 2, 1989).
13. Additional information about recent developments in Delaware law and proposed statutory amendments can be found in a client alert by our firm available at: *https://www.wsgr.com/en/insights/recent-delaware-law-developments-and-proposed-legislative-responses.html.*
14. Wachtell, Lipton, Rosen & Katz, "The Interco Case" (Nov. 3, 1988), *https://www.law.upenn.edu/live/files/7876-culled-martin-lipton-publicationspdf* ("The Interco case[,] and the failure of Delaware to enact an effective takeover statute, raise a very serious question as to Delaware incorporation. New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware.").
15. *See* Ellen Bardash, "A Legal 'Doomsday'?: Delaware Faces Criticism at Tulane Conference," *Law.com* (Mar. 8, 2024), *https://www.law.com/delbizcourt/2024/03/08/a-legal-doomsday-delaware-faces-criticism-at-tulane-conference/;* Rose Krebs, "Del.'s Corp. Law Dominance A Hot Topic At Tulane Conference," *Law360* (Mar. 7, 2024), *https://www.law360.com/pulse/delaware-pulse/articles/1811403/del-s-corp-law-dominance-a-hot-topic-at-tulane-conference*; Theo Francis & Erin Mulvaney, "Elon Musk Isn't the Only Billionaire Fighting Delaware," *Wall St. J.* (Feb. 11, 2024), *https://www.wsj.com/business/elon-musk-isnt-the-only-billionaire-fighting-delawares-grip-on-u-s-business-e9fe299a.*
16. *See, e.g.*, C. Malcolm Cochran, Jason J. Rawnsley, & Katharine C. Lester, "Delaware's Business Courts: The Complementary Nature of the Court of Chancery and the Superior Court's Complex Commercial Litigation Division," *RLF* (May 2014), *https://www.rlf.com/wp-content/uploads/2020/05/10482_CMC-Delawares-Business-Courts.pdf*; Joseph R. Slights III & Elizabeth A. Powers, "Delaware Courts Continue to Excel in Business Litigation with the Success of the Complex Commercial Litigation Division of the Superior Court," 70 *Bus. Law.* 1039 (2015).
17. In 2022, 36 percent of new cases were accompanied by requests for expedition. *2022 Annual Report of the Delaware Judiciary: Court of Chancery* (2022), *https://*

courts.delaware.gov/aoc/annualreports/fy22/doc/Chancery2022.pdf. The number of new cases seeking expedition increased by 8 percent in 2023. *2023 Annual Report of the Delaware Judiciary: Court of Chancery* (2023), *https://courts.delaware.gov/aoc/annualreports/fy23/doc/Chancery2023.pdf*.

18. Kellner v. AIM ImmunoTech Inc., 307 A.3d 998 (Del. Ch. 2023).
19. *See* William M. Lafferty, et al., "Initial Civil Appeals: Delaware," *Practical Law State* Q&A (Mar. 9, 2023), *https://www.morrisnichols.com/media/publication/15232_Initial%20Civil%20Appeals%20Delaware%20_w-000-3316.pdf* (discussing right to appeal directly to the Delaware Supreme Court); *see also, e.g.*, Box v. Box, 697 A.2d 395, 399 (Del. 1997) ("Delaware courts are always receptive to expediting any type of litigation in the interests of affording justice to the parties."); VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1109 (Del. 2005) (resolving expedited appeal in one month); Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 36 n.1 (Del. 1994) (noting expedited appeal resolved in less than three weeks); Sup. Ct. R. 25 ("Upon motion for good cause shown or upon the Court's order *sua sponte*, the Court may order an expedited schedule of any or all procedures, including a shortened time for the filing of briefs and other papers, in any appeal or other proceeding.").
20. Matthew Jennejohn, "How Does Delaware Do It? Judges Alone Don't Explain Chancery's Speed," *CLS Blue Sky Blog* (July 28, 2022), *https://clsbluesky.law.columbia.edu/2022/07/28/how-does-delaware-do-it-judges-alone-dont-explain-chancerys-speed/*.
21. Roberta Romano, "The States As a Laboratory: Legal Innovation and State Competition for Corporate Charters," 23 *Yale J. on Reg.* 209, 225 (2006), *https://media.law.wisc.edu/m/wyjg2/romano-state_innovation_in_corporate_law-2.pdf*.
22. Additional information about recent developments in Delaware law and proposed statutory amendments can be found in a client alert by our firm available at: *https://www.wsgr.com/en/insights/recent-delaware-law-developments-and-proposed-legislative-responses.html*.
23. *See* Salzberg v. Sciabacucchi, 227 A.3d 102 (Del. 2020); Boilermakers Loc. 154 Ret. Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013); Manti Holdings, LLC v. Authentix Acquisition Co., Inc., 261 A.3d 1199 (Del. 2021).
24. Colon v. Bumble, Inc., 305 A.3d 352 (Del. Ch. 2023); Vestal v. Carvana Co, 2023 WL 6311498 (Del.Ch. Sep. 27, 2023).
25. Salzberg v. Sciabacucchi, 227 A.3d 102 (Del. 2020); Boilermakers Loc. 154 Ret. Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013).
26. Additional information on PBCs can be found in a client alert by our firm available at: *https://www.wsgr.com/print/v2/content/227022/Converting-to-a-Delaware-Public-Benefit-Corporation%3A-Lessons-from-Experience.pdf*.
27. *See* Amy Simmerman, David Berger & John Morley, "Anthropic Long-Term Benefit Trust," *Harv. L. Sch. F. on Corp. Governance* (Oct. 28, 2023), *https://corpgov.law.harvard.edu/2023/10/28/anthropic-long-term-benefit-trust/*.
28. Romano, *supra* n.21.
29. *See, e.g.*, Robert Bartlett, "Standardization and Innovation in Venture Capital Contracting: Evidence from Startup Company Charters" (Rock Center for Corporate Governance at Stanford University Working Paper No. 253, 2023), *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4568695* (finding that 54 percent of sample "Series A" financings from venture capital-backed investments used Delaware corporations in 2004, up to 100 percent in 2022, with 2.8 percent of the charters in 2004 being based on the NVCA form, up to nearly 85 percent in 2022); ABA Mergers & Acquisitions Committee, *U.S. Public Target M&A Deal Points Study*, ABA (2024), *https://public.tableau.com/app/profile/aba.deal.points/viz/2024ABADealPointsStudy/Home#1* (finding that 85 percent of public company merger agreements reviewed in the sample set were governed by Delaware law).
30. *See* Adam Chodorow & James Lawrence, "The Pull of Delaware: How Judges Have Undermined Nevada's Efforts to Develop Its Own Corporate Law," 20 *Nev. L.J.* 401 (2020); *see also* Nev. Rev. Stat. § 78.012 ("The plain meaning of the laws enacted by the Legislature in this title, including, without limitation, the fiduciary duties and liability of the directors and officers of a domestic corporation set forth in NRS 78.138 and 78.139, must not be supplanted or modified by laws or judicial decisions from any other jurisdiction."); TripAdvisor, Inc., Definitive Proxy Statement

for 2023 Annual Meeting of Stockholders (Schedule 14A) (April 26, 2023), *https://www.sec.gov/ix?doc=/Archives/edgar/data/1526520/000095017023014532/trip-20230426.htm* (providing a comparison of Delaware and Nevada law).

31. Nev. Rev. Stat. § 78.138(1). A form of the business judgment rule is also codified in Nevada. Nev. Rev. Stat. § 78.138(3).
32. Nev. Rev. Stat. § 78.138(7).
33. Guzman v. Johnson, 483 P.3d 531, 537 (Nev. 2021) ("Applying the same rationale, we now conclude that the inherent fairness standard cannot be utilized to rebut the business judgment rule and shift the burden of proof to the individual directors. Such a standard would contravene the express provisions of NRS 78.138(7) and render meaningless the statute's requirement that the plaintiff must establish a breach involving intentional misconduct, fraud, or a knowing violation of law."); *see also* In re Newport Corp. S'holder Litig., 507 P.3d 182 (Nev. 2022) ("The cases shareholders provide do not substantiate their claims because they apply Delaware's less-forgiving inherent-fairness standard to assess the directors' actions, which Nevada does not.").
34. Nev. Rev. Stat. § 78.139(1). This seemingly represents a doctrinal shift, as there is evidence of heightened standards of review being applied in certain prior case law. *See* Shoen v. SAC Holding Corp., 137 P.3d 1171, 1178 (Nev. 2006) ("In essence, the duty of care consists of an obligation to act on an informed basis; the duty of loyalty requires the board and its directors to maintain, in good faith, the corporation's and its shareholders' best interests *over anyone else's interests*."), *abrogated by* Guzman v. Johnson, 483 P.3d 531, 537 (Nev. 2021); Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1346–47 (D. Nev. 1997) ("ITT argues that Nevada does not follow Delaware case law since N.R.S. § 78.138 provides that a board, exercising its powers in good faith and with an [sic] view to the interests of the corporation can resist potential changes in control of a corporation based on the effect to constituencies other than the shareholders. However, the corporate rights provided under N.R.S. § 78.138 are not incompatible with the duties articulated in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) and Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988). Delaware case law merely clarifies the basic duties established by the Nevada statutes."). For an overview of the Nevada legislature's response to these cases, *see* Chodorow & Lawrence, *supra* n.30.
35. However, Nevada corporate law does recognize that controlling stockholders owe fiduciary duties that are subject to rigorous judicial scrutiny. *Guzman*, 483 P.3d at 541 (Pickering, J., concurring in part and dissenting in part) ("Though superseded as to directors by NRS 78.138—and perhaps due for refinement as to majority shareholders—*Foster v. Arata* states the general rule correctly: A majority shareholder is a fiduciary whose 'dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the ... [majority] stockholder not only to prove the good faith of the transaction but also to show its inherent fairness.'") (citing Foster v. Arata, 325 P.2d 759, 765 (Nev. 1958)).
36. *See* Chur v. Eighth Jud. Dist. Ct. in & for Cnty. of Clark, 458 P.3d 336, 340 (Nev. 2020) ("We therefore take this opportunity to clarify *Shoen*. We reject the district court's determination that *Shoen* provided a separate breach-of-the-duty-of-care claim apart from the strictures of NRS 78.138. Thus, we disavow *Shoen* to the extent it implied a bifurcated approach to duty-of-care and duty-of-loyalty claims, and we give effect to the plain meaning of NRS 78.138. Accordingly, we conclude that NRS 78.138 provides the sole avenue to hold directors and officers individually liable for damages arising from official conduct."); Chodorow & Lawrence, *supra* n.30, at 418 ("In response to a string of judicial decisions misinterpreting and misapplying Nevada corporate law, the Nevada Legislature passed Senate Bill (SB) 203 in June 2017. SB 203 is the Legislature's third attempt to distinguish Nevada and Delaware corporate law.").
37. Simeone v. Walt Disney Co., 302 A.3d 956, 958 (Del. Ch. 2023); eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 33 (Del. Ch. 2010).
38. Nev. Rev. Stat. § 78.138(4).
39. Nev. Rev. Stat. § 78.138(4) ("Directors and officers, in exercising their respective powers with a view to the interests of the corporation, may: Consider all relevant facts, circumstances, contingencies or constituencies, which may

include, without limitation, one or more of the following: (1) The interests of the corporation's employees, suppliers, creditors or customers; (2) The economy of the State or Nation; (3) The interests of the community or of society; (4) The long-term or short-term interests of the corporation, including the possibility that these interests may be best served by the continued independence of the corporation; or (5) The long-term or short-term interests of the corporation's stockholders, including the possibility that these interests may be best served by the continued independence of the corporation.").

40. Nev. Rev. Stat. § 78.138(5).
41. Nev. Rev. Stat. § 78.257; 8 *Del. C.* § 220.
42. *Business Court*, *https://www.leg.state.nv.us/App/InterimCommittee/REL/Document/21387*; Joshua Halen, "Transforming Nevada into the Judicial Delaware of the West; How to Fix Nevada's Business Courts," 16 *J. Bus. & Sec. L.* 139, 162 (2015).
43. *See* Nev. 2D J. Dist. Ct. R. 2.1.; Nev. 8TH J. Dist. Ct. R. 1.61.
44. Halen, *supra* n.42, at 169.
45. *See* The Publications Committee of the State Bar of Nevada, *Nevada Jury Instructions: Civil*, at 295 (2018), *https://ag.nv.gov/uploadedFiles/agnvgov/Content/Issues/09292021_NV-Jury-Instructions-Civil-2018-PDF-version.pdf*; Halen, *supra* n.42, at 165 ("The main concerns of the Business Courts have been its broad subject matter jurisdiction, retention of juries, and unpublished opinions").
46. Nev. Const. art. 4, § 2.
47. *See also* Tesla, Inc., Preliminary Proxy Statement for 2024 Annual Meeting of Stockholders (Schedule 14A) (Apr. 17, 2024), *https://www.sec.gov/ix?doc=/Archives/edgar/data/0001318605/000110465924048040/tm2326076d13_pre14a.htm* (providing a comparison of Delaware and Texas law).
48. Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 719 (5th Cir. 1984) (explaining that, under Texas law, (i) the duty of obedience requires a director to avoid committing ultra vires acts, (ii) the duty of loyalty requires that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances); Ritchie v. Rupe, 443 S.W.3d 856, 868 (Tex. 2014) (citing *Gearhart* with approval).
49. Troy L. Harder & Ian R. Brown, "Corporation Law: Texas," *Practical Law State* Q&A 0-518-6489 (Feb. 15, 2024). The Texas courts have often discussed the duties of officers and directors in the same breath when addressing fiduciary duties. *See, e.g.*, Sneed v. Webre, 465 S.W.3d 169, 173, 178 (Tex. 2015) ("The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion."); Loy v. Harter, 128 S.W.3d 397, 407 (Tex. App. 2004) ("The Texas Supreme Court in Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567 (Tex.1963), noted that corporate officers and directors owe a strict fiduciary obligation to their corporation. Three broad duties stem from the fiduciary status of corporate officers and directors: namely, the duties of obedience, loyalty, and due care.").
50. *Sneed*, 465 S.W.3d at 178 (internal citations omitted).
51. "Governing person means a person serving as part of the governing authority of an entity." Tex. Bus. Orgs. Code Ann. § 1.002(37).
52. Tex. Bus. Orgs. Code Ann. § 7.001. The exculpation exceptions are similar, but not identical, to those found in Section 102(b)(7) of the DGCL, and include: "(1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members; (2) an act or omission not in good faith that: (A) constitutes a breach of duty of the person to the organization; or (B) involves intentional misconduct or a knowing violation of law; (3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or (4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute."
53. *See Ritchie*, 443 S.W.3d at 876 n.27 ("With regard to formal fiduciary duties, this Court has never recognized a formal fiduciary duty between majority and minority shareholders in a closely-held corporation."); Hoggett v. Brown, 971 S.W.2d 472, 488 (Tex. App. 1997) ("Similarly, a co-shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder."); Willis

v. Donnelly, 199 S.W.3d 262, 276 (Tex. 2006) (declining to address whether a majority shareholder in a closely held corporation owes a minority shareholder a general fiduciary duty under Texas law).

54. *See* Flanary v. Mills, 150 S.W.3d 785, 794 (Tex. App. 2004) ("While shareholders generally do not owe each other a fiduciary duty, they may in some circumstances, such as when a confidential relationship exists. A confidential relationship exists where influence has been acquired and confidence has been justifiably reposed. A person is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party, and there exists a long association in a business relationship, as well as personal friendship.") (internal citations and quotations omitted); *Ritchie*, 443 S.W.3d at 876 n.27 (Tex. 2014) ("Informal fiduciary duties arise from a moral, social, domestic, or purely personal relationship of trust and confidence.") (internal quotations omitted).
55. *Hoggett*, 971 S.W.2d at 488 n.13 ("We note that a majority shareholder's fiduciary duty ordinarily runs to the corporation."); Schautteet v. Chester State Bank, 707 F. Supp. 885, 889 (E.D. Tex. 1988) ("Texas courts have properly limited the scope of majority fiduciary duties, because most abuses of majority control constitute breaches of the fiduciary duties the majority owes to the corporation, just as officers and directors owe fiduciary duties solely to the corporation.").
56. Tex. Bus. Orgs. Code Ann. § 21.401(b) (providing that such interests are "the long-term and short-term interests of the corporation and the shareholders of the corporation, including the possibility that those interests may be best served by the continued independence of the corporation.").
57. Tex. Bus. Orgs. Code Ann. § 21.401(d).
58. Tex. Bus. Orgs. Code Ann. §§ 21.401(c), (d).
59. Tex. Bus. Orgs. Code Ann. § 21.401(e).
60. Tex. Bus. Orgs. Code Ann. § 21.218. However, this section does not impair the power of a court, on presentation of proof of a proper purpose by a beneficial or record holder of shares, to compel production of the corporation's books and records regardless of the period during which the shares were held or the number of shares held. Tex. Bus. Orgs. Code Ann. § 21.218(c).
61. Tex. Bus. Orgs. Code Ann. § 10.354.
62. Adolfo Pesquera, "The Business Courts Are Coming—Can They Meet Expectations?," Law.com (July 20, 2023), *https://www.law.com/texaslawyer/2023/07/20/the-business-courts-are-coming-can-they-meet-expectations/*.
63. Tex. Const. art. V.
64. Pesquera, *supra* n.62.
65. *See* Mark C. Walker, "Texas' New Business Courts and Court of Appeals," *Dickinson Wright* (Aug. 2023), *https://www.dickinson-wright.com/news-alerts/texas-new-business-courts-and-court-of-appeals.*
66. *Id.*
67. *Id.*
68. Tex. R. Civ. Pro. 42(i).
69. Tex. Const. art. III, § 5.
70. The common law setting forth the fiduciary duties of directors was codified in Section 309(a) of the CCC, and provides as follows: "A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." California case law also provides that officers who participate in management of a corporation are fiduciaries to the corporation. Brent A. Olson, Cal. Bus. Law Deskbook § 2:25 (2023).
71. *See, e.g.*, Jones v. H. F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969) ("The Courts of Appeal have often recognized that majority shareholders, either singly or acting in concert to accomplish a joint purpose, have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just, and equitable manner. Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business.").

72. *See, e.g.*, Desaigoudar v. Meyercord, 133 Cal. Rptr. 2d 408, 415 (Cal. Ct. App. 2003) ("The business judgment rule is premised on the notion that management of the corporation is best left to those to whom it has been entrusted, not to the courts. The rule requires judicial deference to the business judgment of corporate directors so long as there is no fraud or breach of trust, and no conflict of interest exists. The rule has been codified in Corporations Code section 309.3 which requires a director to perform 'in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.'") (internal citations omitted).
73. Cal. Corp. Code § 204(a)(10).
74. Cal. Corp. Code § 212.
75. Cal. Corp. Code § 302.
76. Cal. Corp. Code § 301.5.
77. Cal. Corp. Code §§ 301(a), 194.7 (A "voting shift" is "a change, pursuant to or by operation of a provision of the articles, in the relative rights of the holders of one or more classes or series of shares, voting as one or more separate classes or series, to elect one or more directors.").
78. Cal. Corp. Code § 311(c). Board committees must also consist of two or more directors. Cal. Corp. Code § 311.
79. Cal. Corp. Code § 110(b); Cal. Corp. Code § 119; *see also* Julia Reigel & Angie P. Flaherty, "California Adopts Ratification and Verification Statute for Corporations," *Wilson Sonsini Client Alert* (Sept. 2, 2022), *https://www.wsgr.com/en/insights/california-adopts-ratification-and-verification-statute-for-corporations.html*.
80. Cal. Corp. Code § 110(b).
81. The California Rules of Court define a complex case fairly broadly, calling it "an action that requires exceptional judicial management to avoid placing unnecessary burdens on the court or the litigants and to expedite the case, keep costs reasonable, and promote effective decision making by the court, the parties, and counsel." *See Complex Civil Guidelines: Guidelines and Protocols Complex Civil Litigation Department*, Superior Ct. of Cal (Feb. 28, 2024), *https://www.scscourt.org/court_divisions/civil/complex/ComplexCivilLitigationGuidelines.pdf* (explaining jury protocols for complex civil litigation department).
82. *Judicial Selection: How California Choose Its Judges and Justices*, Cal. Cts. Newsroom, *https://newsroom.courts.ca.gov/branch-facts/judicial-selection-how-california-chooses-its-judges-and-justices*.
83. *See* 8. *Del. C.* § 503(a).
84. 8 *Del. C.* § 503(c).
85. Ellen Schulhofer & Albert Z. Kovacs, "Corporation Law: Nevada," *Practical Law State* Q&A 9-517-8404, (July 2023).
86. *Franchise Tax Overview*, Tex. Comptroller (2023), *https://comptroller.texas.gov/taxes/publications/98-806.php*.
87. Cal. Rev. & Tax. Code § 23151.
88. Palkon v. Maffei, 2024 WL 678204 (Del. Ch. Feb. 20, 2024).

Converting a Corporation Is Not Domestication

By Keith Paul Bishop

I recently saw that a Delaware corporation had disclosed plans to convert to a Nevada corporation. The Form 8-K filed by this company included the following statement:

> If the Plan of Conversion is approved by the Company's stockholders, the Conversion will take effect upon the filing of a certificate of conversion with the State of Delaware and articles of domestication with the State of Nevada.

Technically, this is incorrect. Nevada law authorizes two different procedures. NRS 92A.195 allows for the *conversion* of a foreign or domestic entity or foreign or domestic general partnership. NRS 92A.270 separately provides that an "undomesticated organization" may become *domesticated*. The Delaware General Corporation Law also has separate statutes governing domestication. DGCL § 388 and § 390 govern domestications and DGCL § 266 governs conversions.

This is no mere cavil. The filing requirements in Nevada are different for each procedure. If a corporation is effecting a conversion, Nevada requires the filing of "articles of conversion." NRS 92A.205(1)(a). If a corporation is effecting a domestication, it must file "articles of domestication." The documents required to be submitted with these filings also differ. For example, an undomesticated organization must file a certified copy of its charter document, or equivalent and a certificate of good standing, or equivalent whereas neither is required to be filed with the articles of conversion.

Other filers conflate the terminology. For example, another issuer sought stockholder approval of a conversion pursuant to NRS 92A.195 but confusingly described the proposal in its proxy statement as "Redomestication to Nevada by Conversion."

Keith Paul Bishop *is a partner of Allen Matkins LLP.*

BOARD STRATEGY

How Should Boards of Directors Engage with the AI Revolution?

By Sarah Dodson and Maggie Welsh

Recently, Maggie Welsh, host of the "AI Counsel Code" podcast, interviewed Sarah Dodson about board-level considerations concerning artificial intelligence (AI). The interview addresses how boards should consider AI within their stewardship and governance roles, focusing on both the risks and opportunities AI presents. This Q&A has been adapted from that discussion between Maggie and Sarah and edited for conciseness and clarity.

Maggie: What is a high-level strategy for boards to consider when they're thinking about AI?

Sarah: What I would encourage board members to consider with respect to AI is its role as an organization-wide strategic imperative. We see many board members naturally focusing on the risks AI presents and taking a protective posture towards managing those risks appropriately. That's a very important element of the board's duties. However, just as important as risk management is understanding the opportunities presented by AI.

With such a potentially disruptive technology, it is important for the board to make sure that the organization they govern can appropriately take advantage of those opportunities and achieve their full potential. So, there are really two sides to the AI question as it occurs in the boardroom: risk, but also opportunity.

Sarah Dodson *and* **Maggie Welsh** *are partners of Baker Botts LLP.*

Taking this more holistic approach and view is critical. To that end, a starting approach for board members is to first understand the company's current and potential use of AI, its competitors' use of AI, and whether there are strategic uses of AI within the organization or the broader industry that aren't yet captured.

Having this conversation with management and understanding how AI can be useful, is currently being used, and the opportunities that exist, is important.

Maggie: What is the best way to figure out the use case and the opportunities for using AI? Is that a conversation with management or does it involve something else?

Sarah: The starting point is absolutely a conversation with management. The company's management team should be thinking about these issues, as AI has captured everyone's attention.

You would be hard-pressed to find a company that isn't thinking: How could we use AI?, How are our competitors using it?, and What are our options?

As a board member, you should talk to management about whether and how it is considering these matters. What have they identified as AI's potential uses? What is management's vision of how it could advance? The conversation with management—a gut check on where they are right now and into the future—is important.

But then, self-education also becomes very important. As a director, it's less about understanding the technical detail and more about knowing

enough to be conversant with AI and being able to spot issues. Directors don't need to be technical experts, but they do need to have a basic grasp of the key issues surrounding AI. Otherwise, it's going to be a lot harder to have meaningful conversations with management around AI strategy and oversight.

Maggie: What are some ways that the board can educate themselves on AI? Do you have any recommendations or best practices for getting up to speed on everything AI?

Sarah: Absolutely. There are a lot of options. As a starting point, as I mentioned, the management team has probably been thinking about AI quite a bit. They will have people on their team who have been looking at these issues. Requesting that management provide a presentation is one easy way to leverage the work the company is already put in to AI.

You can also self-educate through research. There are many great organizations that provide summaries of how AI works and potential use cases. Even better would be to experiment with some AI tools—this is a fun way to better understand the capabilities, the limitations, and imagine different use cases.

Another helpful approach is bringing in outside experts. Say you are serving an organization with a management team that hasn't done as much on the AI front as other teams; they are not as engaged with it as they could be. You can request an outside expert to talk to the board about AI technology, use cases, strategy options and what's happening in that particular industry and gain more information that way.

Finally, there are all kinds of events where you can learn more about AI and get plugged in. Looking for those opportunities is another healthy way to get up to speed on what's happening in AI.

Maggie: Attending conferences, talking to knowledgeable people in the field, and bringing in outside experts who might be able to give training on certain AI issues are all excellent recommendations. So now, assuming the board is up to speed on AI and has enough general knowledge about AI, what is the board's role in directing management to pursue AI applications?

Sarah: The important thing to remember is that the board's role is that of a custodian. The board members won't be the boots on the ground who are actually implementing and effectuating AI within the organization. They are in this key governance role where they need to make sure that management is doing this.

When thinking about the relationship between the board and management, focus on that oversight role and understand what management is doing to take advantage of the opportunities and to appropriately manage the risks.

That can look different for different organizations. If you have an organization that is highly technical, well-resourced and very involved in this space, it is going to be a lot bigger piece of the oversight role, and that might require more effort versus an organization that is small and curious about use cases for AI but otherwise doesn't live and breathe in the AI space.

There also are different ways that you can think about what is the right way to approach oversight from a structural perspective. An important feature is making sure that you have a good process in place. That might entail thinking about who or what is the right constituency to perform the AI-specific oversight role.

For example, you can take an existing board committee and task it with AI oversight. Or it may be the case that given the importance of AI within the organization and its strategic imperatives, the board

should consider forming a new committee that is individually tasked with AI. In addition, identifying the right individuals within the board to really focus on these issues is going to be a very important consideration. For some, a technical background in computer science or data science may prove to be critical. For others, this may not be meaningful.

Maggie: Sarah, you make an excellent point about forming new board committees or having existing board committees focus on AI. Could you give some tips on how you would see these board committees run and operate? What should they be looking for, and what should they be doing to implement some of these AI questions we've been talking about?

Sarah: What these committees do and how they function will vary a lot depending on the organization and its needs. But what's important is that the board members and the committee members are having conversations about what really makes sense for them and their company.

Part of that is asking, what information do we need as a committee to make educated decisions about AI? What metrics might management need to present to us? And with what regularity do we need to receive this information?

Again, we come back to the key point we talked about earlier, which is having a conversation with management and understanding the organization's strategic goals with AI.

If you're asking yourself whether the company should try to optimize an existing function and use AI as an ancillary or a copilot to this, that might look really different from a use case where AI is totally automating an existing workstream or function. Understanding how the company plans to use AI strategically also helps show what information that committee needs and how they can effectively make those decisions.

Maggie: AI is changing so rapidly, and new programs and offerings are released every day. How often should boards revisit AI with management and discuss their different use cases or the metrics you discussed?

Sarah: That's a great question. Let's think about AI in two different ways the organization could be exploring.

One could be, are you creating your own proprietary AI tool within the organization? Is this something you are developing in-house and having to commit capital and other resources to its development?

Or is your organization not in the business of doing that, but rather looking to contract with a third-party vendor that's providing an existing AI tool to help you serve some kind of need?

If you're in the former camp, your organization is putting a lot of time, effort, and energy into developing these tools. You want to make sure that you're appropriately resourced to do that, both from a capital perspective, from a talent perspective, and making sure that your workforce is educated and up to speed on the latest, so that as you develop your product and what you're working on, you're able to do the best you possibly can with it.

That can look very different if you've identified a need or an area where AI can help your business be more effective, but you're not the one creating it. If you're looking to a third party, then your resources will focus on being diligent in how you engage potential providers.

Directors need to understand which provider makes the most sense for their organization. At that point, you're entering into an agreement, and you're leveraging that tool. Boards should have confidence in what that third party is going to be doing, and just as importantly *not* doing, in order to continue to advance and improve on the platform.

So, board interactions with management can look quite different depending on how you're planning

to use AI within the organization. But again, these are the kinds of conversations that you need to have, think about, and approach strategically.

Maggie: How should boards consider workforce allocation?

Sarah: If you have a critical function in your organization that you think is going to be augmented by AI, then you need to think about a few things: Is there a way that we can identify the individuals who are currently supporting that function and address the implementation thoughtfully? Is it providing additional outside training to educate them on how to use the AI tools and to understand how to be effective in that regard? Should the organization assess whether the function is appropriately sized once the AI tools are running?

Alternatively, if you think that AI might be replacing a particular function, is there a way to pivot impacted employees to other areas where they can apply their skills? Can we train them in other areas? And is there a way they can continue to provide value?

It's a huge part of the conversation.

People worry about job replacement. There's something to be said for making sure that people across the board are appropriately educated and understand how AI can impact their existing role. Thoughtful organization and communication in this regard can be incredibly important from a talent management perspective.

Maggie: From the board level, are there any frameworks that the board should consider or that management might consider in its AI implementation?

Sarah: There are so many different companies with varying levels of understanding and familiarity with AI and the potential frameworks that govern its use. From the board level, it's important to understand where management sits in the spectrum. Are they aware of the different frameworks? Have they chosen one to follow?

That could be the National Institute of Standard and Technology (NIST) AI Risk anagement Framework, which is the one we see and refer to most commonly, or it could be something else. But from the board's perspective, having a conversation with management, making sure that they're thinking about these things, and considering what frameworks make sense for their particular organization is important.

Maggie: Thank you for shedding light on AI in the boardroom. As we wrap up, do you have any final thoughts or advice for our listeners?

Sarah: I encourage directors and executives to consider AI very thoughtfully. Boards that can be proactive in understanding, governing, and leveraging AI are putting themselves in the best position to drive positive outcomes for their organizations.

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