



Legal & Regulatory Responsibilities of Boards & Board Members

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Presenters



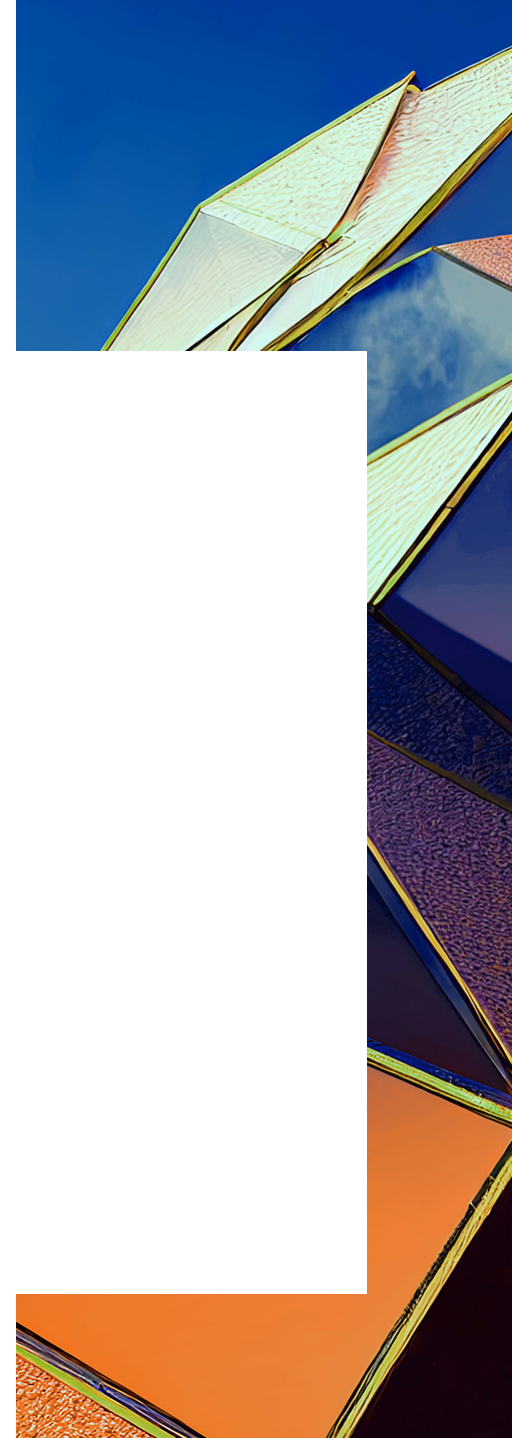
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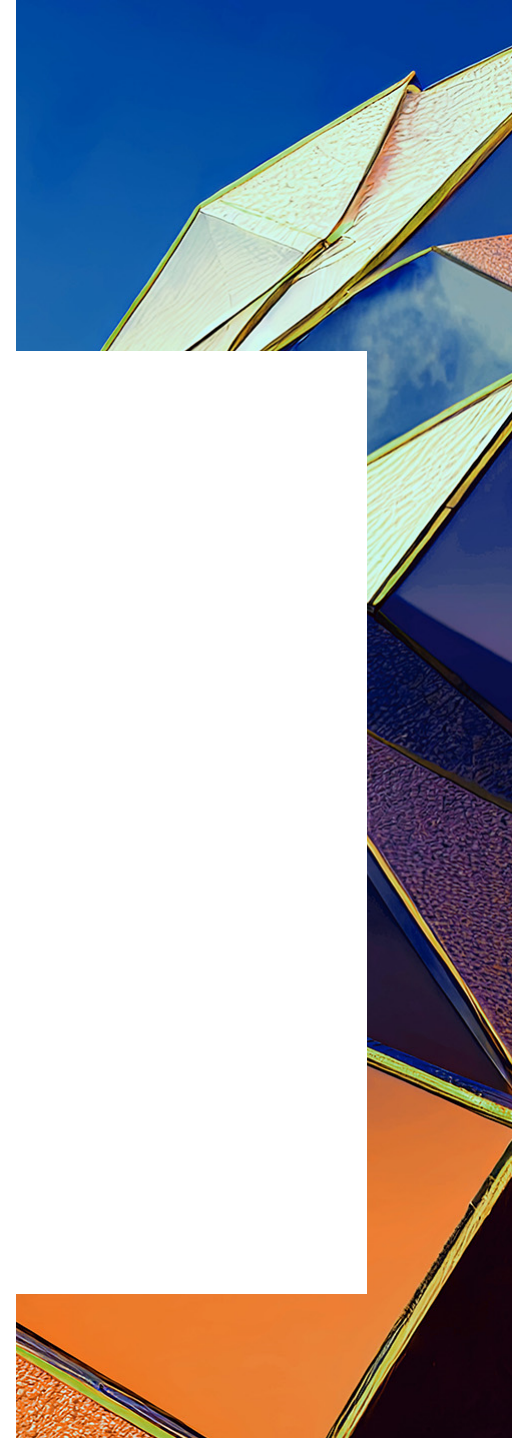
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Agenda

- Director's Legal Duties
- Recent Trends
- Impact of Trends on Board Functions
- Board's Response to Management in Trouble
- Liability Protections



Role of Board - Responsibilities

- Board is responsible for overseeing the business and affairs of its company
 - Approving fundamental operating, financial and corporate plans, strategies and objectives
 - Overseeing risk (*informed* oversight)
 - Evaluating performance of the company and its management
 - Selecting, evaluating, and fixing compensation of corporate officers
 - Preparing for senior management succession
 - Approving SEC filings/disclosures

Director's Legal Duties – Types

- **Director Fiduciary Obligations:**

- 1. Duty of Care**

- Directors must act on an informed basis, in good faith and with the care that an ordinary prudent person in a like position would exercise

- 2. Duty of Loyalty**

- Directors should not use their corporate position to make a personal profit or gain or for other personal advantage

- 3. Duty to Supervise (Oversight)**

Best Practices to Help Satisfy Director's Duty of Care

- Document decision-making and corporate approval process carefully in **Board minutes**
 - Balance between no record of deliberations and keeping transcripts
 - Must be more than a mark-up of last meeting's minutes
 - Reflect substance and process of meeting; **emphasis on factors and reference to policies considered by Board when reaching decisions**
- Get draft minutes out quickly for review by all directors
- Consider how record will look to future audiences (media, court) when sending out advance Board books

Best Practices to Help Satisfy Director's Duty of Care (cont.)

- Hire independent experts, advisors or consultants who report to Board
 - Expert's work product and advice should be delivered directly to the Board or committee, ideally in-person at Board meetings
- Effective follow-up on open issues and director requests should occur—questions or requests for information should not remain unanswered
- Board and its committees should follow their own charters and governance guidelines
- [New] Consideration of constituencies other than shareholders
 - More courts now allowing/requiring consideration of more stakeholders

Duty of Care – Business Judgment Rule

- BJR Standard: Business decisions made by *disinterested directors pursuant to an informed process are legally presumed* to be made on informed basis and in honest belief the decision is best for company, even if the decision turns out to be unwise or unsuccessful
- Legal system will judge directors and the company on the *process* the Board took to make decisions
- BJR protection:
 - Shields directors from personal liability
 - Allows directors to be indemnified and qualify for D&O insurance coverage
 - Enables courts to dismiss meritless shareholder suits at the beginning of a lawsuit
 - Does BJR protection extend to *officers*? Split of authority

Duty of Loyalty – Overview

- ***BJR is Unavailable to Conflicted Directors:***
 - **Director Independence/No Conflict of Interests**
 - Director must not only be “independent” from management/corporation, but also “independent” from the transaction/people at issue
 - **Independence is judged far more rigorously in litigation than NASDAQ/NYSE listing standards!** Can include social relationships, business relationships, other informal ties to management/other directors and to the transaction at issue
 - “Personal” interest need not be financial; can be reputational (*e.g.*, employment issues)
 - **Corporate Opportunity**
 - Directors should not use their position within the company for personal financial gain or other personal advantage

Best Practices to Help Satisfy Director's Duty of Loyalty

- Revisit and refine director independence criteria
 - Consider all financial/social ties between directors and between directors and management
 - Understand conflicting obligations of directors (other boards, full-time jobs, etc.)
 - Annual Board questionnaire is important
 - Board pay usually does not create conflict, but if levels are high, obtain compensation consultant input
 - Also, focus on conflicts of financial/legal advisors
- Expect full disclosure and scrutiny of all conflict of interest situations; approved by disinterested directors after full financial analysis
- Actively enforce company's code of conduct

Recent Trends – Role of Board

1. Heightened Supervisory Role

- Shift to more active management role (The New Paradigm) as protections for directors erode under new duty to supervise standard

2. Increasing Focus on ESG Factors

- Board's focus goes beyond short-term financial gain and looks at long-term value creation driven by additional factors such as societal contribution

3. Multi-Stakeholder Approach

- Broader view of stakeholders (beyond shareholders)

Duty to Supervise – Overview

Boards have an *affirmative duty* to implement a reporting and controls system **and monitor its functioning**

- Prior to 2017, very few successful “failure to supervise” cases
- **Pre-2017 Standard:**
 - “Only a sustained or systematic failure of the board to exercise oversight – such as an utter failure to assure a reasonable information and reporting system exists – will establish ... liability.”
In re Caremark Int’l, 698 A.2d 959, 967 (Del. Ch. 1996)

Duty to Supervise – Overview (cont.)

- Recent DE cases — especially *Marchand v Barnhill*, 212 A.3d 805 (Del. 2019) — changed the protective *Caremark* standard
- **Standard now:**
 - Directors “must make a good faith effort to implement an oversight system and then **monitor** it.”
 - Not just required by the Courts; Regulators require it, too:
 - SEC: *Seaboard* standards
 - DOJ: <https://www.justice.gov/criminal-fraud/page/file/937501/download>

Trend #1 – Heightened Supervisory Role

- **Marchand Facts:**

- Blue Bell Creameries suffered deadly listeria outbreak; 3 consumers died. Massive recall and layoffs ensued. To stay afloat, new financing obtained, but under negative terms
- Management knew of inspection reports raising major concerns about contamination risks, but didn't tell Board
 - Board failed to ensure effective food safety compliance system, and had no mechanism to ensure material food safety issues would be flagged at the Board level
 - No board Risk Committee
 - Board delegated to management public reaction to crisis
- Held:
 - Chancery Court initially dismissed claims under *Caremark*
 - Delaware Supreme Court *reversed*, and allowed claims to proceed to discovery

Trend #1 – Heightened Supervisory Role

- **Extension of *Marchand* to Corporate Officers -- *In re McDonald's***
 - After CEO hired, he in turn hired CHRO who allegedly fostered “party atmosphere” and also personally allegedly sexually harassed and assaulted employees
 - In 2016 and 2018, company-wide employee walkout in over 30 US cities
 - 2018: Board learned of allegations against CHRO; CEO recommended exception from “zero tolerance” policy. Board keeps CHRO but hires consultant, requires training; CHRO continues to violate policy; Board fires him for cause
 - 2019: Board fires CEO for having sexual relations with multiple subordinates, but paid \$40MM+ severance upon ouster
 - Held: *Caremark* claims against CHRO not dismissed; CHRO also held to oversight fiduciary duties (Jan. 2023). *Caremark* claims against Board dismissed (March 2023)

Trend #1 – Heightened Supervisory Role

- **2-Pronged Compliance Oversight Test Adopted in *McDonald's***
 - 1st Prong: “Information System Claims,” where Board lacks information systems and controls designed to provide timely information to address “essential and mission-critical” legal compliance
 - 2nd Prong: “Red-Flags Claims,” where Board’s information systems generated red flags indicating wrongdoing” but failed to respond
 - Note distinction between *legal* “red flags” and *business* “red flags”: courts less-forgiving when *legal* red flags are ignored
- Other Issues:
 - How to document compliance with *officer* fiduciary duties?
 - Will BJR protection be extended to officers?

Trend #1 – Heightened Supervisory Role

- **Boards will now be asking Management:**
 - **What are the “mission-critical” risks** facing our company, considering our industry, our scope of operations, and our mix of products?
 - Note: cultural factors like sexual harassment can be “mission-critical”
 - **What key metrics** do we need to hear about from management to reasonably ensure these risks are being addressed?

Trend #2 – Increasing Focus on ESG

- Environmental, social, and governance (ESG) investing
- **What are ESG Disclosures?**
 - Disclosures on environmental, societal, and governance factors made by public companies to help investors understand risks to the company’s financial performance or other issues, such as the impact of the company’s business on communities

Table 1: Examples of Environmental, Social, and Governance Factors

Environmental	Social	Governance
Climate change impacts and greenhouse gas emissions	Labor standards	Board composition
Energy efficiency	Human rights	Executive compensation
Renewable energy	Employee engagement	Audit committee structure
Air, water, resource depletion, or pollution	Customer satisfaction	Bribery and corruption
Waste management	Community relations	Whistleblower programs
Biodiversity impacts	Gender and diversity	Accident and safety management

Source: GAO analysis of documentation from the CFA Institute, Sustainable Accounting Standards Board, and Principles for Responsible Investment. | GAO-20-530

Trend #3 – Multi-Stakeholder Approach

- In 2019, 181 large-company CEOs joined the Business Roundtable in adopting a multi-constituency approach:

“While each of our individual companies serves its own corporate purpose, *we share a fundamental commitment to all of our stakeholders*”

- “Stakeholders” include **investors, employees, communities, suppliers, customers**
- Legislative adoption:
 - Many states (other than DE) have multi-stakeholder *statutes*
 - Query whether DE will eventually adopt similar approach

Trend #3 – Multi-Stakeholder Approach

Case Study – Twitter

- April 2022: Elon Musk offers \$54.20/share – a 54% premium over the day before he began investing in Twitter and a 38% premium over the then-trading price -- with \$1B+ break-up fee
- BUT: significant customer/employee pushback on offer
- Twitter incorporated in Delaware/subject to *Revlon* rule, *i.e.*, once the board decides to consider offer to buy all/substantially all the company, duty shifts to maximize return to shareholders
- Board accepts Musk offer:
 - Musk attempts to back out of deal, but MAC clause prohibitive
 - Musk arrives as CEO – while also concurrently CEO of Tesla, SpaceX
 - Mass exodus of senior management; eventual mass exodus of technical staff
 - Controversy over new content-policing policy; customers/advertisers leave
- ***Would result have been different in a multi-stakeholder jurisdiction???***

Board Duties in the Time of Social Unrest

- Heightened sensitivity about social, cultural factors
 - Enormous impact on the company's reputation
 - People want to see companies do the right thing, not just say they will
 - But Board needs to be strategic about which social issues they weigh in on
- High demand for chief diversity, equity, and inclusion (DE&I) officers
 - Ensure DE&I officer has an active role & seat at the table
 - Work with DE&I officer to examine company's performance in terms of diversity, equity, and inclusion, with a real discussion about hiring practices, representation at all levels of the company, and pay equity

Board Duties in the Time of Social Media/Unrest



“Walgreens Faces Blowback for Not Offering Abortion Pill in 21 States”



Directors Sued Under New Standards

- Boeing – \$237MM for failure to oversee development of 737Max jets; board separately sued i/c/w \$23MM payout to ousted CEO for #MeToo issues
- Fox News, Wynn Resorts – \$90MM and \$41MM settlements of derivative claims over #MeToo issues
- Google – derivative suits from \$90MM payout to one ousted exec, \$45MM for another
- McDonald's – \$70MM payout for ousted CEO
- 10+ derivative suits (and counting) for failure to diversify board
- However...may be seeing a shift away: WeWork's ousted CEO denied \$185MM payout
- Bottom Line: **Review “For Cause” Termination Clauses in Key Exec Employment Agreements!** Also note new SEC “clawback” rules for financial restatements.



Board's Response to Management in Trouble

Before: "We stand behind our CEO/Management"



Board's Response to Management in Trouble (cont.)

Now: "We're going to get to the bottom of this"*

*And using our own advisors, thank you.



Other Issues on the Horizon

- Super-Voting Stock Agreements – Delaware courts apply BJR, and will typically uphold
- Viability of Forum Selection Clauses
 - Under 8 Del. C. 115 (2015), DE corporations can adopt bylaws requiring “internal corporate claims” to be brought solely in Delaware courts
 - What about federal securities law claims? *Sciabacucchi v. Salzberg* (Del. 2020) blessed bylaw limitations requiring venue for '33 Act claims in federal DE court; but note 7th (con) and 9th (pro) Circuit split re: viability of FSCs for *derivative* securities law claims.
- Challenges to Contractual Stockholder Consent Rights
 - Shareholder challenges contending Board abdicates its duties by giving one shareholder approval over, e.g., CEO selection/termination
- Extension of *MFW* conflicted shareholder framework (i.e., transaction approved by independent Special Committee and “majority of the minority” vote of shareholders) outside of “going-private” context. E.g., *Match Group* (reverse spin-off), etc.

Key Protections: *Exculpatory and Indemnity Clauses*

1. Exculpatory Clause

- DE 102(b)(7) in corporate charters – limits personal liability of directors for monetary damages (but not injunctive relief)
- Statutory protections now extended to Delaware *officers* since August 2022, though need to include in charter to have protection

2. Indemnification Provisions

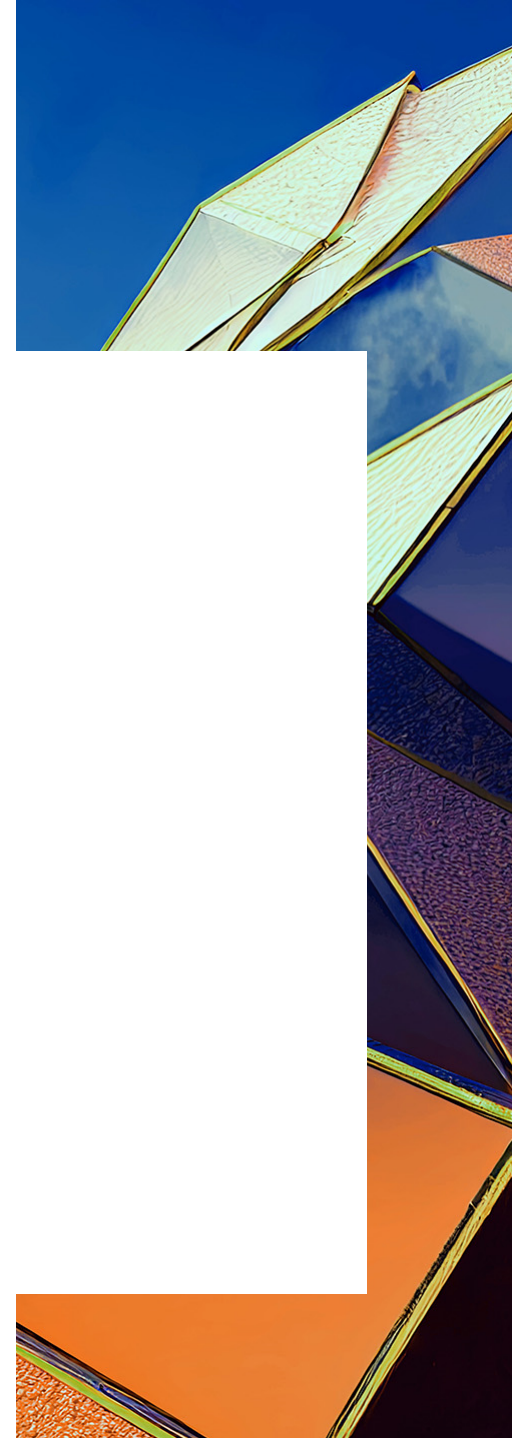
- Ensure you have state-of-the-art corporate indemnification provisions
 - Explore expanded bylaws or individual agreements
 - Indemnification provisions should also include *advancement of legal fees as they are incurred*
 - Certain states have expansive statutory protections

Indemnification and Liability Shields: *D&O Insurance, Forum Selection Clauses*

3. D&O Policy Protections

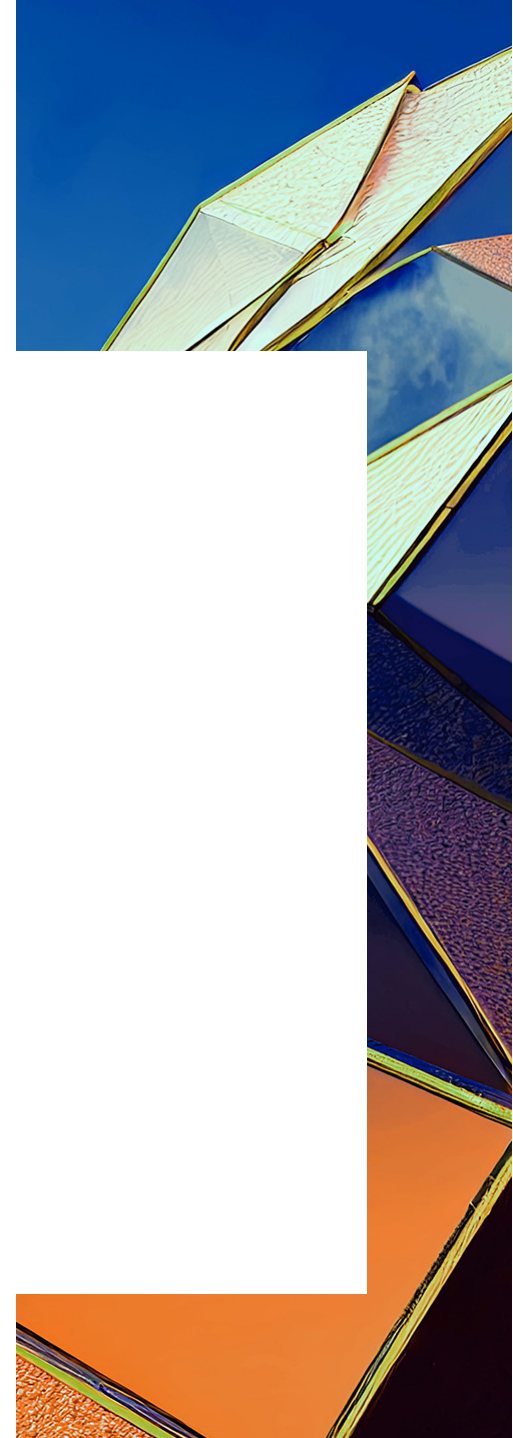
- D&O policies are *not* “One Size Fits All”: *they are negotiable!*
 - Definition of “Claim”: formal litigation or investigation? Or something else?
 - “Bump-up” Provisions
 - Ability to Select Counsel of Choice
 - Retention vs. Policy Limits; Coverage of Individual, vs. Company
- This requires expert advice!

4. Forum Selection Clauses



Thank You

- Questions?



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