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FINANCIAL FRAUD

Earnings Management Red Flags

By Lenin Lopez

Public companies are under tremendous pressure to meet or beat stock analyst earnings estimates. This pressure caused Warren Buffet to observe: "Managers that always promise to 'make the numbers' will at some point be tempted to make up the numbers."[1]

Engaging in tactics designed to meet earnings estimates is commonly referred to as earnings management. Some earnings management techniques may be perfectly legal; others, not so much. This article:

1. Provides an overview of what earnings management is (and isn't).
2. Provides a few examples of Securities and Exchange Commission (SEC) actions related to earnings management.
3. Addresses the "red flags" that boards and management teams should watch for and steps they can take to avoid improper earnings management.

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What Is Earnings Management?

In 1998, in a speech before the NYU Center for Law and Business, SEC Chairman Arthur Levitt famously used the phrase "accounting hocus-pocus" when describing earnings management.[2] He said:

> "Flexibility in accounting allows it to keep pace with business innovations. Abuses such as earnings management occur when people exploit this pliancy. Trickery is employed to obscure actual financial volatility. This, in turn, masks the true consequences of management's decisions."[3]

Chairman Levitt went on to describe "[f]ive of the more popular" techniques used by companies to inappropriately manage earnings.[4]

1. **"Big Bath" Charges:** Deliberately overstating restructuring charges above what is likely. By accelerating expenses and losses into a single year with already poor results, this approach gets all the bad news out at once, and the theory is that Wall Street will then focus on future earnings.

2. **Creative Acquisition Accounting:** Allocating the purchase price to "in-process" research and development, then expensing the costs immediately as a one-time charge to overstate earnings.

3. **"Cookie-Jar" Reserves:** Over-accruing charges for items such as sales returns, loan losses, or warranty costs when the company is doing well and using those reserves to smooth future earnings when the company isn't as profitable.

4. **"Materiality":** Misusing the concept of materiality to intentionally record errors in a company's financial statements such that they improperly get labelled as immaterial. In some cases, this can allow a company to meet earnings projections.

5. **Revenue Recognition:** Prematurely recognizing revenue (e.g., before a sale is complete, before the product is delivered, or at a time when the customer has options to terminate), rather than waiting until the promised product or service has been fully delivered.

The techniques used above generally boil down to misrepresenting financial statements. However, earnings management shouldn't always be equated to "cooking the books."

There are legitimate reasons to manage earnings. For example, a company may decide to postpone an acquisition or disposal of assets until a later period, postpone expenses to a future period when earnings are low, or accelerate expenses when earnings are high.

So where is the line between legitimate and fraudulent earnings management, the latter being the type of earnings management that Chairman Levitt was focused on in his speech and that the SEC views as a basis to bring a related enforcement action? A few SEC enforcement actions will help ground our discussion.

SEC Enforcement Actions Related to Earnings Management

1. General Electric Company: $50 million penalty (2009)[5]

Meeting or exceeding analyst expectations for close to a decade would be music to any investor's ears. General Electric Company (GE) did that from 1995 through 2004.[6] According to the SEC, it was too good to be true.

The SEC conducted a risk-based investigation of GE's accounting practices with a focus on the potential misuse of hedge accounting.[7] As a reminder, in a risk-based investigation, the SEC identifies a potential risk within a particular industry or at a specific company. The SEC goes on to develop an investigative plan to test whether the problem exists. With the potential misuse of hedge accounting as

the basis for the SEC's investigation, the investigation ultimately uncovered four separate accounting violations.[8] This led the SEC to file civil fraud and other charges against GE in 2009.[9]

The SEC's complaint alleged that on four separate occasions, high-level GE accounting executives or other finance personnel approved accounting that wasn't in compliance with generally accepted accounting principles (GAAP).[10]

For instance, the SEC found GE reported end-of-year sales of locomotives that had not yet occurred in order to accelerate more than $370 million in revenue into the quarter.[11] In another example, the SEC alleged that GE made an improper change to its accounting for sales of commercial aircraft engines' spare parts that increased GE's 2002 net earnings by $585 million.[12]

The SEC alleged that GE's motivation was "to increase earnings or revenues or to avoid reporting negative financial results."[13] In one case, GE's accounting tactics allowed the company to avoid missing analysts' earnings per share (EPS) expectations. The complaint also describes shortfalls in internal controls as well as internal flag-raising. One email the SEC uncovered from a senior accountant in GE's corporate accounting group described how this individual believed a particular accounting approach GE intended to use was problematic:

> "How do we intend to deal with the SEC "one strike and you're out" position? Doesn't this mean that potentially we can no longer qualify for cash flow hedging??? Urgent that you find disclosures of others who have had cash flow failures. Isn't this an extraordinarily big deal?"[14]

GE settled the charges for $50 million without admitting or denying guilt.[15] By the time of the settlement, GE had already restated some of its financial statements and taken remedial actions, including improvement to its internal audit and controllership operations.[16] GE noted that it incurred approximately $200 million over four years in associated legal and accounting fees to cooperate with the SEC and conduct its own review.[17]

2. General Electric Company: $200 million penalty (2020)[18]

In 2020, GE found itself the subject of another SEC action.[19] This time, as noted by Reuters, the SEC's investigation was sparked by GE's accounting practices following a 2017 surprise $6.2 billion accounting charge. Once the SEC started looking, their scope of inquiry expanded.[20] The SEC alleged that, between 2015 and 2017, GE failed to disclose that profits attributable to its power and health insurance businesses were largely attributable to a change in accounting method.[21]

For example, the SEC stated that in public disclosures, "GE misled investors by describing its Power segment profits without explaining that more than $1.4 billion in 2016 and $1.1 billion in the first three quarters of 2017 stemmed from reductions in cost estimates."[22] This was all apparently done to conceal the challenges those businesses were facing. Cooley LLP provides a detailed discussion of the action.[23]

The SEC found that GE violated the antifraud, reporting, disclosure controls, and accounting controls provisions of the federal securities laws.[24] GE settled the charges for $200 million without admitting or denying guilt.[25] The penalty would likely have been higher if GE hadn't already taken remedial measures that the SEC viewed as positive. For example, GE replaced certain members of management in its power and insurance businesses, revised certain investor-related disclosures, added internal controls and testing processes, and added disclosure controls and procedures.[26] Notably, the penalty doesn't include legal and accounting costs GE incurred to cooperate with the SEC and conduct its own review. If the case from 2009 is any indication, it's likely the costs were significantly greater than the penalty.

3. Under Armour, Inc.: $9 million penalty (2021)[27]

In 2021, the SEC charged Under Armour, Inc., with misleading investors as to the bases of its revenue growth and certain disclosure failures concerning its future revenue prospects in 2015 and 2016.[28] The SEC's order noted that "[b]y the second half of 2015, Under Armour's internal revenue and revenue growth forecasts for the third and fourth quarters of 2015 began to indicate shortfalls from analysts' revenue estimates."[29] Note that the company had consistently met or exceeded revenue estimates since going public in 2005.[30]

The anticipated miss in sales was partially a function of a warmer winter in North America, which negatively impacted sales of the company's higher-priced cold-weather apparel.[31] The SEC found that in response, Under Armour accelerated, or "pulled forward," existing customer orders that were requested to be shipped in future quarters. Under Armour accomplished this by asking its customers to accept shipments of certain products in the current quarter that they had already ordered for delivery in the next quarter. This allowed the company to meet analysts' revenue estimates.[32] The SEC's order didn't necessarily take issue with the practice of pulling forward customer orders, but it took issue with the company's failure to fully disclose to investors what it had done.

The SEC's order found that Under Armour publicly attributed the increased revenue growth to factors like "growth in training, running, golf and basketball," as well as increased sales in footwear and apparel.[33] Under Armour failed to mention the pulling forward of customer orders. Referring to discussions within Under Armour's senior management and finance function, including some that noted the need to implement pull forwards to make up for "significant and increasing revenue shortfall,"[34] the SEC's order argues that Under Armour knew or should have known that pulling forward customer orders concealed its failure to meet analysts' revenue estimates without such pull forwards.[35] Further, the SEC found that "the company's senior management implicitly admitted the unsustainability of this practice by describing pull forward revenue as "bad," "unnatural," and "unhealthy."[36]

The SEC found that Under Armour violated the antifraud provisions and certain reporting provisions of the federal securities laws.[37] Under Armour agreed to pay a $9 million penalty without admitting or denying the charges.[38]

4. Rollins Inc.: $8 million penalty (2022)[39]

The SEC doesn't just focus on household names like GE and Under Armour. Rollins Inc., a pest control company, made its way onto the SEC's radar in connection with the SEC's Division of Enforcement's EPS Initiative.[40] The SEC's EPS Initiative uses risk-based data analytics to help the SEC uncover potential accounting and disclosure violations caused by, among other things, earnings management practices.[41] The case brought against Rollins is the highest penalty to date against a company in connection with the SEC's EPS Initiative.[42]

Details from the SEC's release announcing the charges:

> The SEC's order finds that, in the first quarter of 2016 and the second quarter of 2017, Rollins, a nationwide provider of pest control services, made unsupported reductions to their accounting reserves in amounts sufficient to allow the company to round up reported EPS to the next penny. According to the order, the company's then CFO, Paul Edward Northen, directed the improper accounting adjustments without conducting an analysis of the appropriate accounting criteria under generally accepted accounting principles (GAAP) and without adequately memorializing the basis for those accounting entries. The order also finds that Rollins made other accounting entries that were not supported by adequate documentation in multiple additional quarters from 2016 through 2018.[43]

Unlike in the other actions brought in connection with the EPS Initiative and other cases discussed in this article, the SEC specifically noted in its release and its order that the Rollins case involved "improper earnings management practices."[44]

A unique aspect of the Rollins case was that the record showed that Rollins' CFO was very involved in directing the company's finance team to make accounting adjustments that appeared to be focused solely on increasing net income. In one instance, the CFO directed the team to make adjustments just after the CFO had met with members of the finance team to discuss "how to manage the unexpectedly low income that was causing a lower-than-expected EPS."[45] In short, the record made this enforcement action a softball for the SEC in terms of the ability to show that Rollins did not simply fail to disclose a change in accounting approach, but rather something more egregious was afoot.

The SEC found that Rollins and the CFO violated antifraud provisions of the federal securities laws and that Rollins violated the financial reporting, books and records, and internal controls provisions of the same.[46] The order also found that the CFO caused Rollins' violations of the financial reporting, books and records, and internal controls provisions of the federal securities laws.[47] Without admitting or denying the SEC's findings, Rollins and its CFO agreed to pay penalties of $8 million and $100,000, respectively.[48]

Boards and Management Teams: Watch for These Red Flags

The following are a few common red flags related to earnings management that boards and management teams should watch for:

1. **Discussions regarding "meeting analysts' expectations" and "making our numbers."** These are a hallmark of SEC cases related to earnings management and should be viewed as red flags since they can create an environment where improper earnings management practices can sprout—or at least give that impression when actions are reviewed after the fact by the SEC. For example, a CFO may emphasize to her direct reports that the company is feeling pressure to meet its numbers. Without intending it, that message may be misinterpreted by some direct reports to mean that they and their team need to find creative ways to help in the effort to meet the company's numbers. The concern, of course, is that those efforts may cross the line into improper earnings management.

2. **Consecutive periods of closely meeting or exceeding analysts' expectations.** This will undoubtedly garner congratulations during earnings call Q&As, as well as investor interest, but may also be a red flag in the eyes of the SEC. This is especially the case if these periods end with a sudden drop in earnings per share (EPS). I liken this to a track athlete who is breaking world records. As congratulations come in, so do questions as to whether that athlete is getting any extra help in the form of performance-enhancing drugs (PEDs). For companies that are meeting or exceeding analysts' expectations, the analogous PEDs question is whether the company may be engaged in improper earnings management.

3. **Transactions not in accordance with company accounting policies or changing policies so that they are.** Whether it is an internal accounting policy, authorization matrix, or something similar, companies aren't generally lacking when it comes to policies. Ignoring, bending, or changing those policies should be considered red flags, especially when those actions result in improved financial outcomes.

4. **Creative or unusual transactions/accounting.** As boards and management teams review drafts of a company's periodic reports and earnings materials, here are some examples of key questions they can

ask to discern whether the company may be using improper earnings management techniques: Are revenues changing in a way the narrative disclosure fails to fully and clearly explain? Are cash flows remaining steady while revenues rise dramatically? Did the company's EPS benefit significantly from "nonrecurring" transactions (e.g., writing down assets or establishing a restructuring reserve)? If any of these occurred during the last quarter of the company's fiscal year, it is an especially prudent time to ask questions.

5. **"Immaterial" errors.** A company may be compelled to correct financial statements or update disclosure to cleanse previous misstatements of performance. Of course, any company would prefer to avoid a re-issuance restatement or a "Big R" restatement. Unfortunately, this could cause a company to attempt to find a way to shoehorn what would otherwise be a material error into the immaterial error category. WilmerHale provided a great discussion of the types of red flags to watch for when assessing errors in financial statements, including circumstances where a quantitively small error could be material when considering qualitative factors.[49] As a reminder, a "Big R" restatement occurs when a company must prepare an accounting restatement to correct errors in previously filed financial statements that are material to those financial statements.

   This also requires the filing of a Form 8-K to restate those financial statements. This is a blemish on the perceived reliability of a company's ability to report accurate and complete financial statements and could also result in other adverse consequences (e.g., drop in share price, attracting the attention of regulators, shareholder lawsuits, or clawback of executive compensation). Compare this to an immaterial error, where the error can be corrected in the period that the error was identified and a company can generally avoid the parade of Big "R" restatement horribles.

Tips for Avoiding Improper Earnings Management

Here are more tips to help avoid improper earnings management, as well as being put under the microscope by the SEC for inadequate disclosure of accounting practices:

1. **Tone at the top.** Earnings management may start off with a few small accounting tactics that can be rationalized as working within the bounds of generally accepted accounting principles (GAAP), only temporarily, or to avoid the volatility that would be detrimental to shareholders' best interests.

   To avoid having a gray area turn into an enormous black eye, the board and upper-level management should emphasize integrity in financial reporting as part of the company's ethical culture. Management can also train functional areas within the business that touch the company's financial statements and related disclosures on improper earnings management. Pairing this training with a culture where employees feel comfortable reporting potential issues ensures that management and the board will be primed to address potentially problematic issues early.

2. **Maintaining strong internal controls and robust documentation practices.** A common denominator in cases related to earnings management is subpar internal controls. In the Rollins case discussed above, accounting adjustments were made without adequate documentation. If your company gets a knock on the door from the SEC regarding one of your accounting decisions, lack of documentation is a bad look.

   Instead, companies should conduct an analysis of the appropriate accounting criteria under GAAP and memorialize this exercise with contemporaneous documentation. There should also be controls in place to ensure that individuals, whether that is the CFO or a manager in finance, be limited in the amount of discretion they can exercise in making accounting decisions.

3. **Fulsome review of MD&A.** It's important that the board and management conduct a fulsome review of the MD&A. As a reminder, the Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A) is a section of a company's annual report or quarterly filing. It's where the company provides a narrative explanation of the financial statements and other statistical data that it believes will enhance a reader's understanding of its financial condition, changes in financial condition, and results of operation.

   Thinking back to the Under Armour case discussed above, the SEC's inquiry started with an accounting issue, but the SEC ultimately brought charges based on the company's failure to disclose the pulling forward of customer orders. It's possible that thoughtful inquiry by the board into management's decision to pull forward sales could have led to a few additional lines in the MD&A, likely avoiding SEC charges altogether.

   One practice that can help ensure an effective review of the company's MD&A by the board is the preparation of pre-read materials that highlight, among other things, changes in accounting policies or new business strategies implemented during the period covered by the report, as well as how those changes are reflected and/or disclosed in the report.

4. **Ensure all accounting treatments conform to existing policies.** Before a company diverges from its normal policy, the reason for the divergence should be vetted, and as appropriate, the policy should be revised. In addition, consideration should be given to the company's disclosure. The general theme here is that companies should ensure that disclosure provides a reasonably complete and materially accurate representation of the company's financial condition, results of operations, and outlook.

   For instance, if a change in an accounting practice makes the difference between meeting or exceeding analysts' expectations, that practice should be disclosed in the company's periodic report and earnings materials.

Parting Thoughts

Improper earnings management often starts with a decline or anticipated decline in the business, coupled with pressure to meet internal or external expectations. Even if the SEC doesn't find improper earnings management, the SEC may bring charges based on inadequate disclosure of accounting practices. Be mindful of the earnings management red flags and implement the recommended steps described above—it will go a long way to keeping your company out of harm's way.

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Building Your ESG Program: A Step-By-Step Guide

By Waheed Hassan

The path to developing an ESG program includes a number of steps, which can be worked on concurrently sometimes and not necessarily sequentially. Here's our analysis of the primary four steps:

Step 1: Building Your Team

Assembling a strong team with the appropriate knowledge, bandwidth, and authority is the critical first step to building out a successful ESG program, but it often poses some initial challenges.

Overcoming the Challenges

The chief obstacles in launching an ESG program typically are:

1. ***Limited Bandwidth and Availability*** – New ESG teams consisting of current employees will likely be brought in from other teams. These individuals will have existing duties and responsibilities to prioritize, and they may also experience an extended learning curve if they are transitioning into the ESG field for the first time.

   External ESG hires will also experience an initial learning curve and require training within your company to properly assess and implement your ESG strategy based on your unique positioning and needs.

   This acclimation is the first challenge most companies have. Planning ahead to prioritize an efficient onboarding process will ensure employees can manage their time and current responsibilities, and new hires can get the information they need to start their work.

2. ***Limited ESG Knowledge*** – Many people placed on your ESG team will have little background in ESG-related matters. Although this is common, it can be intimidating to craft sound strategy and workflows without previous ESG experience. Even those with an ESG background find it challenging to keep pace with rapidly evolving regulations and demands of stakeholders.

3. ***Limited ESG Foundation*** – When starting an ESG program, you will be building an initiative from scratch. This is unlike financial reporting, which has decades of established laws and standards. Your company will not have guiding disclosures and internal controls that ensure you are collecting relevant and reliable data.

Waheed Hassan (waheed@zmhadvisors.com) is Founder & CEO of ZMH Advisors.

the Corporate Governance advisor

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4. ***Limited Authority*** – Without authority and buy-in from company leadership, ESG teams face an uphill battle. A successful team must define authority in terms of oversight to lead and build strategy, with cooperation from appropriate internal teams.

Building the Team

ZMH Advisors have identified the types of traits that work best when launching an ESG program:

1. ***Project Management*** – The ESG team leader should have a sound project management skillset. The job of assessing a company's current positioning requires the ESG team to collaborate cross-departmentally to collect diverse information.

2. ***Organization*** – Creating processes that can be replicated and improved upon requires systematic documentation of contacts, processes, outcomes, and learnings. This also creates the initial groundwork for future auditing. Ensuring these documents are properly saved and organized in a consistent and logical way is essential to maintaining proper systems.

3. ***Communication*** – Persuasive, consistent, and personalized communication is necessary to maintain positivity within your team, obtain the deliverables you seek from others within the company, and ensure the ESG team is collaborating with each other to lay proper foundations.

5. ***Team Player*** – The ESG team often is pulled from different silos, and a lack of a formal "team" designation can result in different priorities and reporting structures. "Team player" attitudes will create more cohesion and foster robust communication to ensure fewer rifts.

6. ***Resourcefulness*** – Commonly, proper resources are not allocated to building a strong ESG program due to a lack of buy-in from senior leadership or understanding of the scope of this project. Internal ESG teams will need to advocate for prioritizing ESG initiatives within the company.

Step 2: Developing an ESG Strategy

After your ESG team is assembled, you will need to craft a sustainability strategy that aligns with the company's overall mission and business plan.

In developing a sustainability strategy, you will need to consider these major drivers:

1. Who are our key stakeholders when it comes to ESG?

2. What ESG topics are relevant to those stakeholders? What KPIs are commonly reported for those topics? What should our priority metrics and targets be?

3. How should we identify and prioritize our various ESG goals so that they are best integrated with our company's existing business strategy?

Who Are Our Key Stakeholders?

Keep this broad; your initial stakeholders can include investors, regulators, customers, suppliers, employees, and the communities in which you operate. Nearly all institutional investors have prioritized ESG topics- everything from climate change to social impact issues. Each year, the voting policies of these investors are increasingly more proactive; they are looking for real change, not a "check the box" attitude.

Employees are paying greater attention to their company's stance towards ESG. Employees want to take pride in what their company is doing for DEI, climate change mitigation, ethical operations, and supporting their communities. Consequences to failing the ESG test are showing up as high attrition rates and low morale.

Increasingly, customers are asking suppliers to ensure robust ESG compliance, as part of their global sustainability commitments. If you have a compelling ESG strategy, it is important to communicate that to your customers to potentially expand your base and increase retention.

Your suppliers are part of your overall ESG profile. Their sustainability policies and activities impact yours – and vice versa. Many suppliers are asking for ESG-related disclosures as they get ready for possible Scope 3 emissions reporting.

Regulators, like the SEC, are actively implementing new regulations that will establish broad disclosure requirements and compliance obligations for both climate and social topics. This is happening on a global scale and can be challenging to keep abreast of rapidly evolving regulatory developments.

How Should We Identify and Prioritize Our Various ESG Goals So That They Are Best Integrated with Our Company's Existing Strategy?

Before you can set your ESG strategy, you need to identify the foundational pieces of your company. This data is often sourced from departments that are not accustomed to disclosing this kind of information because it is not part of the regular financial reporting process. There can be pushback from those asked to participate in collecting data due to limited availability or a lack of understanding.

Without this foundation, it's difficult to figure out the next steps. Senior leadership needs to set expectations, company-wide, that ESG is necessary to the company's overall business strategy moving forward.

Once you have these foundational strategy and positioning pieces, your leadership and board will help you deliberate on how to move forward; this is an ongoing process that should be revisited regularly. Agility during this process is crucial for success.

What ESG Topics Matter Most to Our Stakeholders? And What Should Be Our Metrics and Targets to Achieve Better Alignment?

Your ESG strategy should be realistic, specific, and genuine. ESG strategies should not serve marketing priorities, nor should they be positioned as "checking the stakeholder's box." There are significant legislative, financial, and reputational consequences to an inauthentic ESG strategy, also considered "greenwashing."

For institutional investors, develop an engagement program where you are periodically discussing material ESG topics with them. You will need to be educated about their ESG priorities, relevant voting policies, and shareholder proposals they are most likely to support. Investor information changes rapidly, and you may need to leverage additional resources to help you consolidate and simplify this data. ZMH's "ESG Dashboard" can help you understand the nuances of investors' ESG priorities and voting policies in this ongoing process.

Market research into industry-standard metrics, targets, and KPIs will help you identify how you compare to your peers, where you may be an outlier, and where your focus points are. When deciding which metrics and targets to use, you'll need to consider what type of information you'll be required to publicly disclose. The concept of "materiality" plays into that, and ZMH Advisors has a materiality assessment service that can assist you with this crucial piece of the ESG puzzle for your company.

Step 3: Setting Targets & Metrics

After your team creates a strong ESG strategy, you'll need to establish a framework to execute it. An important part of this step is knowing

what to consider in your target-setting process. This will enable you to choose the right metrics to track your progress.

If you're a public company, it's helpful to know what the SEC has proposed as future disclosure requirements for Greenhouse Gas (GHG) emissions, however, you should not be limited to the SEC's mandated disclosures (when finalized) as there are demands from other key stakeholders beyond regulators.

Under the SEC's proposal, companies would be required to disclose the baseline year for their GHG emission targets, which would need to be consistent for all targets designated by each company. Many companies set near-term, medium-term, and even long-term targets. For those with overlapping commitment targets, such as a goal of net zero emissions by 2050 pursuant to the Paris Agreement, or a plan to cut Scope 1 and 2 emissions by 50% by 2030 and reduce Scope 3 emissions by 35% by 2030, they would be required to disclose all necessary targets.

Other elements of the SEC's climate disclosure proposal would require reporting on:

- The scope of activities and emissions included in the target;
- The unit of measurement, including whether the target is absolute or intensity-based;
- The defined time horizon by which the target is intended to be achieved, and whether the time horizon is consistent with one or more goals established by a climate-related treaty, law, regulation, policy, or organization;
- The defined baseline time period and baseline emissions against which progress will be tracked with a consistent base year set for multiple targets;
- Any interim targets set by the company;
- How the company intends to meet its climate-related targets or goals;
- If a company uses carbon offsets or Renewable Energy Credits (REC)[1] in its plan to meet targets and goals, there would need to be disclosure about the amount of carbon reduction represented, the source of the offsets or RECs, a description and location of the underlying projects and the cost of the offsets or RECs; and
- How the board sets climate-related targets or goals and oversees progress against those targets or goals, including the establishment of any interim targets or goals.

Beyond the SEC's proposal, you should keep abreast of other industry standards and frameworks, including:

- ***Regulators*** – The International Sustainability Standards Board (ISSB) is a standard-setting body established in 2021 under the direction of the IFRS Foundation, whose mandate is the creation and development of sustainability-related financial reporting standards to meet investor needs for sustainability reporting. The ISSB is expected to finalize a set of standards in 2023 and the SEC is expected to work from ISSB's standards.
- ***Rating Agencies*** – There are numerous rating agencies that investors use to help them determine whether to invest in your company and what level of commitment is appropriate. CDP and the Dow Jones Sustainability Index are organizations that rate companies only if the company completes their questionnaire. Others, such as MSCI, ISS ESG, ISS QualityScore, and Sustainalytics, create assessments of your company based on publicly available information.
- ***Institutional Investors*** – Institutional investors have their own investing guidelines, as well as voting policies. You will need to maintain current information on changes in stewardship & voting policies of the investors that are important to you. You may also receive requests for information from investor coalitions. It's always in your best interest to talk

to them, as it may head off a shareholder proposal down the road.

- ***Industry Trends & Peers*** – Participate in forums within your industry to keep abreast of trends that impact your industry, and read disclosures made by peer companies to ascertain what their goals and metrics are as well as how they're progressing.

When deciding which metrics and targets to use, you'll need to consider what type of information you'll be required to publicly disclose. The concept of "materiality" plays into that and we'll dig into that complex concept in our next chapter.

Step 4: Materiality Assessment

Companies undertake ESG "materiality" assessments to identify pertinent ESG disclosures that might be material to a reasonable investor, inform stakeholders on relevant information, and advise ESG teams on how to better execute business strategy. They are a crucial first step in the reporting process, and help internal teams focus on what matters.

Financial Materiality

The SEC's final rules on climate disclosure, expected to emerge in the second quarter of 2023, likely won't disturb the "financial materiality" concept that practitioners have long been acquainted with.

The SEC's rule proposal last year focused on "financial materiality," defined as "information that can have an impact on public companies' financial performance or position and may be material to investors in making investment or voting decisions." The SEC did not explore the notions of "double," "dynamic," and "nested" materiality in its rule proposal – likely due to the looming specter of a legal challenge over its authority to do so. However, you should be familiar with these alternative definitions as global regulators and stakeholders may ask you to provide climate disclosures beyond "financial materiality."

Single materiality is inwardly focused: "how does this impact the company?"

Double materiality is both inwardly and outwardly focused: "how does this impact the company as well as our stakeholders?"

Nested materiality essentially is a hybrid of the single and double materiality standards.

Dynamic materiality is materiality that may be changeable or fluid over time.

"Reasonable Investor"

The input of your independent auditors when making a materiality determination is invaluable, as well as inevitable in most cases. The auditors will be applying the SEC's Staff Accounting Bulletin No. 99 – and a statement last year from the SEC's Chief Accountant is a good primer on how to apply SAB 99.[2]

The financial materiality analysis is made through the lens of a "reasonable investor." This is can be an elusive threshold because materiality determinations are challenged with the benefit of hindsight. What might seem reasonable to you might not to a court tasked with deciding whether your materiality determination is actionable.

What type of ESG information does a "reasonable investor" react to? Stock price movements aren't the final word when analyzing which disclosures are material, but they can be instructive. A recent study – "Which Corporate ESG News Does the Market React To?" conducted by George Serafeim and Aaron Yoon found that stock prices react only to industry-specific financially material ESG news, and the reaction is larger for news that is positive, receives more news coverage, and relates to social capital (relative to natural or human capital) issues.[3]

There are many reasons to disclose all material ESG information publicly. Investors might use a company's ESG disclosures (or lack thereof) to help them determine whether to submit a shareholder proposal to that company. A company's ESG disclosures could lead investors, and stakeholders, to undertake an activist campaign against management.

Line-Item Requirements

In addition to the judicial "reasonable investor" threshold, there are a number of line-item requirements in the SEC's regulations that elicit ESG disclosures. In other words, companies are required to make these types of ESG disclosures even though a reasonable investor might not deem them to be material. In a sense, the SEC's mandated rules make them de facto material.

When the SEC adopts final climate disclosure rules in the near future, there will be a host of these line-item requirements in the climate arena. Proposed new Item 1501 and 1502 of Regulation S-K has a host of various climate-related requirements ranging from assessing "physical risks" and "transition risks" to carbon offsets and internal carbon pricing. As noted in a Reuters' article, companies should be planning their data strategy now to meet the coming line-item requirements.[4]

The SEC bolstered rules that have resulted in more social disclosures, particularly focusing on human capital and board diversity, and will be proposing new rules for human capital disclosures by the end of 2023. Since the Sarbanes-Oxley Act and Enron, there has been an extensive list of governance line-item requirements that will surface in the coming years.

Protecting Yourself

Protecting yourself when making a materiality decision is key, particularly when *not disclosing* something. A misleading disclosure can pose trouble, but an omitted disclosure can have serious consequences. It is essential to identify a system of feedback from leadership when determining which disclosures to fulfill.

When internal disclosure controls are being implemented with an applied financial materiality analysis, there is an inherent heightened risk. Having proper resources to ensure you are properly navigating these new processes is essential for success.

Notes

1. Renewable Energy Credit – a tradeable, market-based instrument that represents the legal property rights to the "renewable-ness"—or non-power (i.e., environmental) attributes—of renewable electricity generation. (Source link)

2. *https://www.sec.gov/news/statement/munter-statement-assessing-materiality-030922?utm_medium=email&utm_source=govdelivery*.

3. *https://www.tandfonline.com/doi/full/10.108‰15198X.2021.1973879*.

4. *https://www.reuters.com/legal/legalindustry/upcoming-sec-climate-disclosure-rules-bring-urgency-esg-data-strategy-planning-2023-01-30/*.

ESG Meets Disclosure Controls in an SEC Enforcement Action

By Dan Goelzer

On February 3rd, the Securities and Exchange Commission announced an administrative enforcement action against Activision Blizzard Inc. (Activision), a video game development company.[1] The SEC charged that Activision failed to maintain disclosure controls and procedures to collect information relating to the company's ability to attract and retain talented personnel – one of its disclosed risk factors. (Activision was subsequently the subject of a high-profile state proceeding alleging a hostile work environment, including sexual harassment.)

The SEC's action seems to reflect the extension of the concept of securities law disclosure controls and procedures into the area of workplace misconduct, at least in cases where employee attraction and retention have been identified in risk factor disclosure as a key business risk.

The SEC also charged Activision with using its separation agreements to inhibit departing employees from communicating with the SEC staff about potential securities law violations. Without admitting or denying the Commission's allegations, Activision agreed to settle the matter by paying a $35 million civil money penalty and ceasing and desisting from further violations.

Dan Goelzer is a retired partner of Baker McKenzie, a major international law firm. He advises a Big Four accounting firm on audit quality issues. From 2017 to July 2022, Dan was a member the Sustainability Accounting Standards Board. The SEC appointed him to the Public Company Accounting Oversight Board as one of the founding members, and he served on the PCAOB from 2002 to 2012, including as Acting Chair from 2009 to 2011. From 1983 to 1990, he was General Counsel of the Securities and Exchange Commission.

Disclosure Controls and Procedures

Between 2018 and 2021, Activision's risk factors disclosure included an item headed, "If we do not continue to attract, retain, and motivate skilled personnel, we will be unable to effectively conduct our business." Among other things, this risk factor stated that the company's "success depends to a significant extent on our ability to identify, attract, hire, retain, motivate, and utilize the abilities of qualified personnel, particularly personnel with the specialized skills needed to create and sell the high-quality, well-received content upon which our business is substantially dependent."

Securities Exchange Act Rule 13a-15 requires SEC reporting companies to maintain disclosure controls and procedures "designed to ensure that information required to be disclosed * * * is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure." The SEC alleges that Activision violated Rule 13a-15 by failing to maintain "controls and procedures among its separate business units designed to collect or analyze employee complaints of workplace misconduct." As a result, of the lack of such controls and procedures, "complaints related to workplace misconduct were not collected and analyzed for disclosure purposes."

The SEC does not allege that Activision actually committed any disclosure violations. The gravamen of the charge is that, since the company did not have controls and procedures that collected information about employee complaints, personnel responsible for disclosure were unable to make an informed assessment of whether the disclosure was warranted. (While not mentioned in the SEC order, in 2021, the

California Department of Fair Employment and Housing filed a lawsuit against Activision Blizzard, alleging widespread discrimination and harassment of female employees at the company. In response to the lawsuit, over 2,000 current and former employees signed an open letter criticizing the company's handling of harassment and discrimination allegations.)

Impeding Whistleblowers

SEC also charges that Activision's agreements with departing employees violated the SEC's whistleblower protection rules because former employees were required to notify the company if they received a request for information from a government agency. Specifically, a clause in Activision's standard separation agreement stated: "Nothing in this Separation Agreement shall prohibit . . . disclosures that are truthful representations in connection with a report or complaint to an administrative agency (but only if I notify the Company of a disclosure obligation or request within one business day after I learn of it and permit the Company to take all steps it deems to be appropriate to prevent or limit the required disclosure)."

Securities Exchange Act Rule 21F-17 prohibits "any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation." The order finds that the notice clause in the separation agreements "undermines the purpose" of Rule 21F-17, although the order adds that the Commission is not aware of any specific instances in which a former Activision employee was prevented from communicating with SEC about potential violations of the securities laws or in which Activision took action to enforce the notification clause.

Commissioner Peirce's Dissent

Commissioner Hester M. Peirce issued a statement dissenting from the Activision order. As to the disclosure controls and procedures charge, she emphasizes that the order does not allege that Activision's disclosures were at any time misleading or incomplete. She also points out that the logic of the order is potentially very far-reaching:[2]

> If workplace misconduct must be reported to the disclosure committee, so too must changes in any number of workplace amenities and workplace requirements, and so too must any multitude of factors relevant to other risk factors. The requirement cannot be that a company's disclosure controls and procedures must capture potentially relevant, but ultimately—for purposes of disclosure—unimportant information. * * * Using disclosure controls and procedures as its tool, [the Commission] seeks to nudge companies to manage themselves according to the metrics the SEC finds interesting at the moment. * * * [T]oday, that metric is workplace misconduct statistics, but other issues will follow.

Commissioner Peirce also disagreed that the Activision separation agreements violated whistleblower protection rules. She notes that the order does not explain how the notification requirement impedes former employees from communicating with the Commission.

Comment: The Activision order appears to be a product of the SEC's ESG enforcement taskforce. If nothing else, the case illustrates that the Commission's interest in ESG isn't limited to greenwashing or inaccurate disclosures and that it is prepared to be aggressive and imaginative in finding links between substantive corporate failings in ESG areas like a hostile workplace environment and the federal securities laws.

For audit committees and managements, a point to consider is what the Activision case says about the relationship between risk factor disclosure and disclosure controls and procedures. As Commissioner Peirce's dissent suggests, the order could be viewed as indicating that, for every material risk set forth in the risk factors, there need to be procedures to capture

information that could be relevant to determining whether or not additional disclosure concerning that risk is necessary.

Given the broad array of risks that are typically described, viewing disclosure controls and procedures through that lens could in many cases suggest the need for additional controls. Managements and audit committees may particularly want to consider whether the company's disclosure controls and procedures capture information in ESG areas that have been flagged as key to the business, even if those areas are not directly tied to financial reporting or compliance with specific disclosure requirements.

Notes

1. *https://www.sec.gov/litigation/admin/2023/34-96796.pdf*.

2. *https://www.sec.gov/news/statement/peirce-statement-activision-blizzard-020323*.

Chancery Expands Caremark Parameters—But Dismisses Claims Against McDonald's Directors Because They Took Action to Address Sexual Harassment Once They Learned of It

By Gail Weinstein, Philip Richter, Steven Epstein, Warren S. de Wied, Andrew J. Colosimo, and Erica Jaffe

In *In re McDonald's Corp. Stockholders Derivative Litigation* (Mar. 1, 2023), the Delaware Court of Chancery, at the pleading stage of litigation, dismissed the derivative claims, brought against former and current directors of McDonald's Corp., that alleged the directors had failed to fulfill their duty of oversight with respect to rampant sexual harassment at the company. Vice Chancellor Laster agreed with the plaintiffs that "red flags" had put the board on notice about the problem; but the Vice Chancellor dismissed the claims on the grounds that, once the directors had learned of the problem, they took action to address it (albeit arguably deficient action).

In an earlier decision in the case (issued Jan. 25, 2023), Vice Chancellor Laster had rejected the dismissal of the *Caremark* claims asserted against McDonald's former head of human resources, David Fairhurst, with respect to his alleged lack of oversight of the sexual harassment problem (and his own alleged sexual harassment and misconduct). With the dismissal of the claims against the directors, the case will now proceed solely against Fairhurst (who, allegedly, did *not* take action to address the sexual harassment problem).

Key Points

- **On the one hand, *McDonald's* appears to expand the potential for *Caremark* liability beyond the parameters many legal analysts had understood to apply.** In the two decisions issued in the case, the court has articulated or clarified, for the first time, that: (i) *Caremark* duties of oversight apply not only to directors but also to officers; (ii) *Caremark* duties apply not only to a company's "mission critical risks" but, depending on the facts, may apply to other key risks even if not rising to the level of "mission critical"; and (iii) sexual harassment and similar issues—and, indeed, "maintaining workplace safety" and "tak[ing] care of the corporation's workers"—are mission critical risks for companies.
- **On the other hand, however—and perhaps most importantly as a practical matter—*McDonald's* reinforces that there is a high bar to a finding of *Caremark* liability.** The court emphasized that it is only when directors or officers act in bad faith that *Caremark* liability arises. The court stressed that directors or officers who acted to address a problem of corporate misconduct once they learned of it generally would not be deemed to have acted in bad faith, even if the actions they took were insufficient or reflected poor decision-making (so long as they were not so off the mark as to suggest bad faith).
- **The decision is not inconsistent with the court's earlier decision to reject dismissal of the *Caremark* claims against Fairhurst.** The court's dismissal of the claims against the directors is based on the directors having taken actions to address the sexual harassment problem once they learned of it. By contrast, Fairhurst—who was the specific person responsible for overseeing and preventing

Gail Weinstein, Philip Richter, Steven Epstein, Warren S. de Wied, Andrew J. Colosimo, and Erica Jaffe are Partners of Fried, Frank, Harris, Shriver & Jacobson LLP.

sexual harassment at the company; who allegedly himself promoted the toxic culture that led to the rampant sexual harassment; and who himself had participated in the sexual harassment—allegedly knew about the problem but did nothing about it until the board got involved.

Background. After the board installed Stephen Easterbrook as CEO of McDonald's, he promoted Fairhurst to be Executive Vice President and Global Chief of People (*i.e.*, head of the human resources function). Allegedly, Easterbrook and Fairhurst were very friendly with each other and together engaged in and promoted a party-type atmosphere, with excessive drinking and sexual harassment, at the company and its restaurants.

In October 2016, more than a dozen company employees filed complaints with the EEOC alleging sexual harassment and retaliation. That same month, company employees engaged in a walkout in over thirty U.S. cities to draw attention to the EEOC complaints. In May 2018, the company faced a second round of similar EEOC complaints; and, in September 2018, company employees from ten cities organized a one-day strike to protest sexual harassment at the company—which events were covered in the national media and, in December 2018, prompted inquiries to the company from a U.S. Senator.

Also in December 2018, the board received reports that Fairhurst had engaged in sexual harassment and assault against employees, which acts had been verified by the company's Compliance Department. The board's Audit Committee, following Easterbrook's recommendation, made an exception to its zero-tolerance policy for sexual harassment and, instead, permitted Fairhurst to continue in his position, but cut his bonus and had him sign a letter in which he acknowledged that his conduct had violated company policy and harmed the company and he agreed that he would cease the misconduct.

In late 2019, the board, after learning that Easterbrook had been engaged in more prohibited relationships with company employees than the board had known about, negotiated a separation agreement with him and terminated his employment without cause. After learning that Fairhurst was continuing to engage in sexual harassment, the board terminated his employment for cause. Starting at the end of 2018, the management (including Fairhurst) and the board addressed the sexual harassment problem at the company.

Company employees brought class action lawsuits alleging systemic, pervasive problems with sexual harassment (including assault and rape); a general lack of sexual harassment training; general refusal of the human resources department under Fairhurst to help workers relating to these issues; and retaliation against employees making complaints. Employee surveys indicated that more than 75% of women employees (and even higher numbers at corporate-owned restaurants as compared to franchised restaurants) had suffered sexual harassment at the company and most had also been subject to retaliation for reporting it.

In a January 2023 decision in the case, Vice Chancellor Laster, at the pleading stage, rejected the dismissal of *Caremark* claims against Fairhurst. In this most recent decision, the Vice Chancellor dismissed the *Caremark* claims against the directors. The case will now proceed against Fairhurst alone.

Discussion

"Red flags" had put the board on notice about the sexual harassment problem at the company. The court viewed the following as constituting "red flags":

- the second round of EEOC complaints; the ten-city strike by employees to bring attention to the company's sexual harassment problem; and the letter from a U.S. Senator inquiring about the problem—which together constituted a "collective red flag"; and

- Fairhurst's own sexual harassment coming to light—which, standing alone, constituted an "indisputable red flag." (The court wrote: "When the head of human resources has engaged in multiple acts of sexual harassment, that is enough to put directors on notice of problems in the human resources area.")

The board acted to address the sexual harassment problem once it learned of it. The court cited the following actions:

- In January 2019, management reported to the board's Strategy Committee about the issue and advised that teams of employees were proactively working to modify and improve policies and training programs on sexual harassment and creating a safe workplace.

- In May 2019, management reported on these issues to the full board.

- In June 2019, with management's participation, the Strategy Committee met to discuss the sexual harassment issues and the actions being taken to address it, including a review and revamping, with outside expert assistance, of the company's training programs; a new hotline for employees; a shared values commitment to be signed by franchisees; a best practices guide for franchisees for maintaining a safe and respectful work environment; listening sessions to promote continuous improvement; and an end to the company's mandatory arbitration policy for harassment and discrimination claims.

- In September 2019, the board received an update on the company's enterprise risk management that identified a "Respectful Workplace" as a "New Risk Theme" at the "Top Tier 2" level.

- In November 2019, when the board learned of Easterbrook's improper relationship with an employee, the board terminated him (albeit without cause); and, when it learned that Fairhurst had again engaged in sexual harassment, it terminated him (with cause).

There was no basis on which to infer bad faith by the board. The court emphasized that *Caremark* liability will not arise for directors or officers unless the failure of oversight involved bad faith. Bad faith, in the *Caremark* context, involves a conscious, knowing, and intentional disregard of oversight duties. Even if such actions arguably were insufficient or reflected bad decision-making, *Caremark* liability will not arise unless the board takes actions that are so far beyond the bounds of reasonable judgment as to suggest bad faith.

The court acknowledged that there was some evidence "suggesting that the [board's] interventions in 2019 did not fix the problem." But fixing the problem "is not the test," the court wrote. "Fiduciaries cannot guarantee success, particularly in fixing a sadly recurring issue like sexual harassment. What they have to do is make a good faith effort." In this case, the directors "responded to the red flags regarding the toxic culture"; and, "[b]ecause of the effort they made, it is not possible to infer that the Director Defendants acted in bad faith."

Certain questionable board actions did not indicate bad faith. The plaintiffs contended that several of the board's decisions indicated bad faith—namely, elevating Easterbrook to the CEO position (when the board knew at the time that he was engaged in an improper relationship with an employee); after learning about Fairhurst's sexual harassment and misconduct, giving him several chances rather than terminating him (notwithstanding the company's zero-tolerance policy on sexual harassment); and exercising discretion to terminate Easterbrook *without cause* (which resulted in his receiving a substantial severance payment).

The court disagreed, stating that these decisions were "classic business judgments" as to which a majority-independent board was entitled to a presumption of good faith unless the decisions lacked any rationally conceivable basis. At worst, the court stated, the decisions may have implicated the directors' duty of care, but even if so there would not be any actionable claims as

the company's charter exculpated directors from liability for duty of care violations.

The board's separation agreement with Easterbrook did not constitute "corporate waste." In addition to their claim that the separation agreement indicated bad faith, the plaintiffs contended that the agreement constituted corporate waste as it permitted Easterbrook to receive separation benefits, including a substantial severance payment, notwithstanding his misconduct. A transaction constitutes waste when it is so one-sided that no rational person acting in good faith could approve it.

The court explained that the decision to enter into the agreement was within the purview of the board's business judgment and "[did] not suggest a decision so extreme as to be inexplicable on any basis other than bad faith." The court noted that the company obtained "meaningful corporate benefits" from the agreement—namely, ending the tenure of a CEO who had engaged in an improper relationship; securing the CEO's swift exit and a letter of apology; a release of potential claims by him against the company (without giving him a release); his committing to cooperate with the company on post-termination matters; his agreeing to non-competition, non-solicitation, and non-disclosure provisions; and the likelihood of avoiding litigation with him that would have highlighted the sexual harassment problem at the company that the company was trying to put behind it.

The court stated that (contrary to a commonly held view) *Caremark* duties do not apply only to "mission critical risks." The phrase "mission critical risks" has acquired "talismanic importance in the aftermath of *Marchand v. Barnhill*," the court stated. However, the court emphasized that in *Marchand* (2019) the Delaware Supreme Court stated that while the *Caremark* doctrine "may require more," it "at least" requires attention to "central compliance risks"; and the Supreme Court held in that case that food safety was a "central compliance risk" for the ice cream manufacturer involved because it was "essential and mission critical" to producing and selling ice cream.

Vice Chancellor Laster stated in *McDonald's* that, although, based on *Marchand*, it is fair to infer that "all 'essential and mission critical risks' qualify as 'central compliance risks,' it is also possible that some 'central compliance risks' may not reach the level of 'essential and mission critical.'" In other words, the court explained, just because *Caremark* liability attaches to mission critical risks does not rule out that it may also attach to central compliance risks that are *not* mission critical. "The extent to which [a *Caremark* claim that a board failed to put into place a reporting and monitoring system] might extend to other risks depends on the facts," the court wrote.

Further, the court noted that *McDonald's,* unlike *Marchand*, involved a *Caremark* claim relating to ignoring red flags about potential harm to the corporation (a "Red-Flags Claim") rather than a *Caremark* claim relating to the failure to put an oversight system in place (an "Information Systems Claim"). "The *Marchand* decision actually holds that when directors fail to make any effort to establish an information system to address central compliance risks, then that failure supports an inference of bad faith," the court wrote.

In the Red-Flags Claims context, the court stated, the concept of central compliance risks plays a different role. In this context, the issue is whether the defendant directors or officers consciously ignored corporate misconduct that they knew about. The mission critical concept is relevant in this context, the court stated, in that, "all else equal, if a red flag concerns a central compliance risk, then it is easier to draw an inference that a failure to respond meaningfully resulted from bad faith."

But that does not mean that directors and officers "can ignore red flags about other risks," the court stated. "[A] Red-Flags Claim is not dependent on the signal [*i.e.*, the red flag)] relating to [a]…mission critical risk" and "[t]he plaintiffs [in *McDonald's*] therefore were not obligated to plead that the red flags associated with the Company's culture of sexual harassment and misconduct involved a mission critical risk…."

In any event, the court found it "easy to draw a pleading-stage inference" that "maintaining employee safety" *is* mission critical for companies. "Assuming that hurdle [(of sexual harassment and misconduct being a mission critical risk)] did exist, the plaintiffs cleared it," the court wrote. "It is easy to draw a pleading-stage inference that maintaining employee safety is…mission critical." The court explained: "Fiduciaries must act in good faith to maximize the value of the corporation over the long-term…. Employees perform the work that affects the value of the corporation.

To remain true to the fiduciary principle and build value over the long term, corporate fiduciaries must take care of the corporation's workers." More specifically, the court stated that "[s]exual harassment and misconduct render the workplace unsafe…[and] can result in serious injury to the corporation…[, including by] jeopardiz[ing] the corporation's relationship with…employees, creat[ing] a risk that customers and clients will defect to competitors, and subject[ing] the corporation to potential liability under state and federal law."

In addition, the court noted that, in this case, McDonald's internal documents (discovered in the plaintiff's Section 220 investigation) reflected that the company itself, once it began to address the sexual harassment and misconduct issue, presented it in various corporate materials as a mission critical risk for the company. "The court does not have to infer that sexual harassment and misconduct constituted a mission critical risk. The Company said it," the court wrote.

Practice Points

- **A board and management should not ignore red flags of corporate misconduct and should act to address the misconduct, whether it relates to a "mission critical" risk or not.** The clearer the red flag, the more it relates to a mission critical-type of risk, and the less the board or the officers do to address the problem, the greater the potential for liability under *Caremark*.
- **A board and management should pay attention to corporate misconduct that jeopardizes employees' welfare.** It is unclear what the implications will be of the court's holding that "taking care of the corporation's workers" is a mission critical risk for companies. Clearly, companies should review, update, and monitor their policies, processes, and training relating to sexual harassment (and similar risks, such as discrimination) to ensure that current best practices are in effect and being enforced.

  Those officers who have direct responsibility for employee welfare, and those officers or directors who themselves engage in misconduct within the sphere of their own oversight responsibility, will face a higher risk of potential liability under *Caremark*. (We note also that the January decision in McDonald's indicated that an officer or director who engages in sexual harassment—or, potentially, we would note, violation of other company policies—such that the company is harmed, may have liability for a duty of loyalty violation, apart from liability under *Caremark* for a failure of oversight duties.)
- **A board and management should keep in mind the risks associated with departing from an existing zero-tolerance policy with respect to sexual harassment or similar policies.** A board generally should consider, and document, its reasons for making an exception to a zero-tolerance policy. In addition, when entering into a separation agreement with an officer who is being terminated for misconduct under any such policy, the company should seek to ensure that any such agreement provides meaningful corporate benefits (which may include a likelihood of avoiding litigation with the employee, as well as the employee's waiver of potential claims and the employee's agreement to non-compete, non-solicitation, and/or non-disclosure provisions).
- **With respect to general *Caremark*-related best practices:** Risk management considerations should be a corporate priority and should be integrated into the company's corporate strategies and decision-making generally.

Generally, a board should: be active in establishing the effective management of key risks as a corporate priority; identify the key risks facing the company and delegate responsibility for oversight of these risks to specific board committees; consider setting a regular schedule for reporting from management on key risks and be proactive in seeking out additional reports when appropriate; not simply delegate to senior officers of the company the management of key risks, but become informed about and consider how those risks are managed; proactively address "red flags" (as well as "yellow flags") about corporate misconduct, particularly (but not exclusively) relating to key risks; create a record (such as in board minutes) of its risk monitoring and oversight efforts; and when recruiting new directors, take into consideration the board's expertise in addressing regulatory and other key risks (such as cybersecurity and human resources management).

Generally, management should: establish regular processes and protocols requiring management to keep the board apprised of key regulatory compliance and other practices, risks, or reports; inform the board when it learns of "red flags" (or "yellow flags") about corporate misconduct (including, for example, complaints or reports from regulators or whistleblowers), particularly when it involves key risks; include the board in the company's whistle-blower process; tailor risk management strategies to the company's specific circumstances and risk profile; and inform the board of the practices of other companies in its industry or peer companies with respect to oversight of mission-critical risks.

Practical Steps for Increased Board Effectiveness

By Lillian Tsu and Emily Arndt

Over the past year, public companies have faced an onslaught of external pressures, including an uncertain economy, an ongoing pandemic with changing rules and best practices, and increasing demands from various stakeholders. The coming year looks to continue the trend with a volatile market and economic/political conditions, increasing regulatory demands, and shareholders looking for active engagement.

How prepared a company is to handle these external factors depends in no small part on the strength of its board of directors. An effective board is critical for company success, even in the absence of such difficulties. Increasingly, companies and their shareholders are focusing on selecting, evaluating, and maintaining an effective board.

Entering 2023, here are key issues companies and boards should consider to enhance board effectiveness.

Identifying Needs Through Meaningful Board Evaluations

Nearly all major public company boards conduct annual board evaluations, but not every company is able to glean clear, actionable feedback from those evaluations. Standard written board evaluations may be an efficient way to comply with annual obligations to self-assess, but they may not elicit enough information to provide meaningful insights into board effectiveness and provide a path forward to increased board efficacy. Some companies are turning to alternative evaluation formats to better assess how their boards can improve.

Lillian Tsu and Emily Arndt are attorneys of Cleary Gottlieb Steen & Hamilton LLP.

Next Steps:

— Consider the various formats for conducting a board evaluation (including written questionnaires, one-on-one interviews, group discussions (led by a member of the board or by a third party)) and determine whether an alternative format may elicit more or different feedback from the board.

— Board evaluations can alternate from year to year. For example, a board can opt for one-on-one interviews once every two or three years in order to more deeply explore certain themes or topics.

— Consider using advisors to assist in structuring an evaluation process that can provide more meaningful feedback. Also, depending on the particular dynamics and personalities on the board, an advisor may be best placed to facilitate the interview or discussion, as well as guide potential follow-up.

— Consider seeking feedback from senior executives as part of the board evaluation process. Senior executives may have insight on additional skills or expertise that would be helpful to have on the board.

— Board evaluations should seek feedback not only on an individual's performance as a director but also on the performance of the board as a whole, as well as its committees.

Enhancing the Diversity of Skills and Backgrounds Through Board Refreshment

Diversity continues to be a focus of stakeholders, including at the board level. Increasing board diversity can be accomplished through either (i) expanding the board to add directors with diverse skills and backgrounds or (ii) a more

comprehensive board refreshment process. For some companies, the latter option may be more appealing as a way to promote and enhance board effectiveness, as well as potentially deal with lingering issues, shareholder pressure, or directors with longer tenure than desired.

Management, however, may find it difficult to initiate a board refreshment process. One question we often hear is "how do I get my board on board with board refreshment?" In order to be successful in achieving a refreshed and more effective board, it is critical for board refreshment to be led by the board and particularly by key directors, which can be a long-term process.

Next Steps:

— Consider linking a board refreshment process with the company's long-term strategic plan so board skills are aligned with where the company views its business in the future.

— Identify areas in which new directors with a diverse skillset and background can strengthen the board and contribute to a more effective board. Present a board skills matrix to showcase where there may be gaps in expertise. Be specific in what skills and backgrounds could enhance the effectiveness of the board, focusing on what can be gained in terms of diversity in background and expertise by a comprehensive board refreshment process. Elicit feedback from board members on what additional skills they would value in new directors.

— Avoid focusing on which directors may be a target for replacement in a comprehensive board refreshment process when initially discussing the concept with the board. Focus on the benefits to board diversity and effectiveness rather than on potential impacts to individual directors.

— Enlist support from the chairs of the board and nominating and governance committees, and prepare over time for them to lead conversations with individual directors.

— Plan for a long runway—the board refreshment process is oftentimes a multiyear process involving a comprehensive evaluation of the current board and multiple director searches.

Highlighting Board Effectiveness to Stakeholders

As companies prepare for their upcoming board election cycle, they should consider the importance of using enhanced disclosure to highlight the attributes of an effective board. Particularly given stakeholders' focus on board diversity and the new rules on universal proxy cards, not to mention potential SEC rules relating to climate and cybersecurity, disclosure of director skills, expertise and qualifications is particularly important.

Next Steps:

— Evaluate which directors have received lower support from shareholders in previous annual votes. For those directors who have received less support, consider how to enhance disclosure in the proxy statement to highlight those directors' skills and qualifications, including what unique contributions each director has made to the board in order to generate more shareholder support.

— Directors should be encouraged to take a fresh look at their biographies and qualifications and consider emphasizing skills, qualifications, and expertise that contribute to the business and strategy of the company.

— Narrowing the expertise set of each director to their deepest skill sets, rather than trying to fill the skills matrix with checks, may highlight the value of each director and indicate a cohesive and well-balanced board.

— Consider whether other forms of affirmative outreach are warranted for directors, including posting personal videos to allow shareholders to get to know the directors and their contribution to the board.

FAQs for Those Who Want to Join Startup Boards

By Natasha Allen

Unless you've been or worked with a startup executive who has regular interactions with a board and regular attendance at board meetings, you're unlikely to know what a startup board looks like, how it functions, and what you can do to make a big impact. Being a board director is one of the greatest ways to add value, help businesses thrive, and become an industry leader in your domain. The problem is, there's not a lot of great information out there about how to get started.

1. **What are reasons someone would want to be on a startup board**?

   Being on a startup board is a good way to pivot into serving on public boards, if that is your aspiration. Some people also serve on boards because they are asked and have the correct expertise to assist a startup at that time of their corporate life cycle.

2. **How does someone prepare themselves to get on their first board**?

   Networking is critical. You need to let people know what you are looking for in terms of being on a startup board and how you think you can assist. Having those discussions with people will help strength your narrative as to why you can benefit an organization. There are also board-ready courses. Assess the value and appropriateness such courses for your level of experience.

3. **What are some tips for interviewing for a board seat**?

   Obviously, know the company, not only the names of the leaders and their general business, but anticipate some pain points that you can assist them to navigate. How can your skill set help the company at this stage of growth and make sure you can articulate that in your interview.

4. **What are some of the corporate governance considerations as a board member?**

   Board members need to remember their fiduciary duties. They are stewards of the common stockholders and need to ensure that all actions are in the best interest of the company and the stockholders.

5. **How do you know if you're doing a good job as a board member?**

   Ask for feedback. Have discussions with the C-suite to determine whether you are giving them the support they need to run their business.

6. **Some last thoughts…**

   Board members should recognize that their skill set may not be appropriate for all stages of a startup. Board members should be cognizant that as startups evolve or even pivot it may be time for them to step down to make room for board members that can take the company through its next stage of development.

Natasha Allen is a partner based in the Silicon Valley and San Francisco offices of Foley & Lardner LLP, where she serves as Co-Chair for Artificial Intelligence within our Innovative Technology sector, Co-Chair of the Venture Capital Committee, and is a member of the Venture Capital, M&A and Transactions Practices.

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