Key Takeaways

Skadden

SEC Reporting & Compliance and Corporate Governance Series

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Reevaluating the Board Risk Oversight Process: Implications of *Marchand* and Other Recent Developments

On February 26, 2020, Skadden held a webinar titled "Reevaluating the Board Risk Oversight Process: Implications of *Marchand* and Other Recent Developments." The panelists were **Edward Micheletti**, litigation partner and Delaware litigation practice leader; **Susan Saltzstein**, litigation partner and co-deputy head of Skadden's nationwide Securities Litigation Group; and **Ann Beth Stebbins**, senior M&A partner with a focus on cross-border transactions. Delaware litigation counsel **Sarah Runnells Martin** helped prepare the materials.

The webinar focused on a number of important developments in Delaware corporate law, as well as on recent guidance relating to the SEC's non-GAAP regulations, and how the panelists believe the developments might drive stockholder litigation efforts in 2020. Specifically, the discussion focused on (i) recent decisions relating to *Caremark* oversight claims; (ii) the increasing importance of books and records demands and litigation under 8 Del. C. § 220; (iii) recent case law discussing potential officer liability issues; and (iv) the SEC's enforcement of and shareholder's focus on the equal prominence of GAAP financial measures in disclosures. In particular, the webinar's focus on recent developments in Delaware law pertaining to oversight duties is especially relevant in light of the current impact COVID-19 is having on businesses and the economy.

Below are high-level takeaways on each topic.

Caremark Oversight Claims

As a subset of the fiduciary duty of loyalty, directors owe a duty to monitor the company's operations. Failure to make a good faith effort to adequately monitor operations can result in an action asserting oversight liability — otherwise known as a "*Caremark*" claim (based on the seminal Delaware decision in this area). To state an oversight claim under Delaware law, a plaintiff must establish that either (i) the directors completely failed to implement any reporting or information systems and control, or (ii) having implemented such systems or controls, the directors consciously failed to monitor or oversee its operations, including by turning a blind eye to "red flags" they knew or should have known indicated risks or problems requiring their attention.

Two recent cases illustrate how oversight claims can withstand a motion to dismiss. In 2019, the Delaware Supreme Court found that a complaint adequately stated an oversight claim because the board had not implemented any reporting or information

systems or controls. In *Marchand v. Barnhill*,[1] the court held that a stockholder complaint against the directors of Blue Bell Creameries stated a claim that the board failed to adequately exercise operational oversight relating to events leading up to a listeria outbreak in the company's ice cream (its only product) that ultimately killed three people and forced Blue Bell to shut down its operations. This decision was followed by the Court of Chancery's decision in *In re Clovis Oncology, Inc. Derivative Litigation,*[2] which sustained an oversight claim in connection with Clovis Oncology's reporting of its clinical trial results for its only promising drug candidate, on the theory that the board's existing reporting systems identified several red flags that the board missed.[3]

Takeaways from these decisions include:

- *Caremark* claims remain a viable source of liability for directors, and the recent *Marchand* and *Clovis* decisions may give rise to an uptick in oversight claims in the Delaware courts.
- Courts considering oversight claims are focused not only on the existence of information and reporting systems but also on the board's monitoring of those systems.
- Courts are particularly focused on oversight of "mission critical operations," which are especially important in companies that have one or a limited number of products or operations.
- Courts are particularly focused on oversight responsibilities at companies subject to substantial federal or state regulation.
- Boards can demonstrate active oversight systems by having in place committees specifically addressed to monitoring "mission critical" operations, having in place processes or protocols for management to inform the board of key business risks, and scheduling regular meetings for the board to evaluate key business risks and whether the company's oversight procedures are functioning properly.
- Boards also should carefully document their oversight efforts in formal minutes.

Oversight Duties and COVID-19

Delaware law offers straightforward, basic principles, including the duty of oversight, that guide boards of directors and provide them with flexibility when addressing even the most unique and complicated circumstances, such as the impact COVID-19 is having on businesses. From an oversight standpoint, boards should be aware that, in times of crisis, it is important to focus on maintaining or augmenting board-level reporting and oversight structures so that they receive the information they need to assess and address business risks. In addition to the other takeaways identified in this memo, boards (or applicable committees) may conclude that more frequent meetings or further augmentation of existing controls may be warranted to address COVID-19-related concerns. For a further discussion on considerations for boards of directors on the COVID-19 crisis, see the Skadden client alert "Thoughts for Boards of Directors on the COVID-19 Crisis" (March 20, 2020).

Books and Records Demands

Books and records demands are increasingly being used by stockholders, in particular in connection with derivative litigations, which is how oversight claims are most commonly raised. Courts have indicated that as part of a Section 220 demand, they may grant access to some limited amount of electronic records (including, but not limited to, emails), particularly when key discussions occur in electronic format and are not formally documented in minutes or other board materials.[4] Courts also may allow limited depositions of corporate representatives to determine in what form corporate records exist and whether access to electronic documents is necessary to satisfy a Section 220 demand.[5]

- Books and records demands will continue to be a tool used by plaintiffs prior to filing derivative actions.
- Keeping accurate formal corporate records remains important and may defeat a request to inspect emails and other types of electronic documents.

Officer Liability

Several recent cases have focused on liability of corporate officers, with some cases sustaining claims against officers based on the fact that they are not afforded the protections of exculpatory charter provisions. Under Delaware law, officers owe fiduciary duties of care and loyalty, but unlike directors, officers are not covered by a company's Section 102(b)(7) exculpatory provision for money damages stemming from breaches of the duty of care. In *Morrison v. Berry,* the Court of Chancery refused to dismiss duty of care claims against the company's general counsel and CEO in connection with their role in preparing disclosures that

[1] No. 533-2018 (Del. June 18, 2019).

[2] No. 2017-022-JRS (Del. Ch. Oct. 1, 2019).

[3] Despite these two decisions, several other decisions during this time frame dismissed oversight claims, finding boards satisfied their oversight responsibilities. *Rojas v. Ellison*, No. 2018-0755-AGB (Del. Ch. July 29, 2019); *In re LendingClub Corp. Derivative Litig.*, No. 12984-VCM (Del. Ch. Oct. 31, 2019); *McElrath v. Kalanick*, No. 181,2019 (Del. Jan. 13, 2020).

[4] *KT4 Partners LLC v. Palantir Tech. Inc.*, No. 281, 2018 (Del. Ch. Jan. 29, 2019).

[5] See *Lebanon County Emps. Ret. Fund v. AmerisourceBergen Corp.*, No. 2019-0527-JTL (Del. Ch. Jan. 13, 2020).

were ultimately found to be incomplete. Likewise, in *Voight v. Metcalf*, the Court of Chancery sustained claims against a CEO in his capacity as CEO, even though he also was a director. It is possible that complaints alleging oversight claims may include claims against officers.

- When officers serve on the board of directors, claims that they took actions in their capacity as officers are not exculpated.
- Even if officers did not act in bad faith, claims against them may survive if they acted with gross negligence.
- Officers who are actively involved in preparing disclosures that are later found to be misleading may potentially face liability in connection with those disclosures.
- If a board has given an officer instructions about how to implement a compliance program, monitor its results and report back to the board, the officer can breach his fiduciary duties by failing to properly carry out those instructions.

Non-GAAP Financial Measures

Boards of public companies have oversight responsibility over financial reporting to ensure that investors and markets have high-quality, reliable financial information. Nearly all public companies report non-GAAP metrics in their financial statements, as this information can give investors a better understanding of a company's business. However, non-GAAP measures can also be confusing to investors, due in part to their lack of uniformity and the prominence in their presentation. When a company discloses non-GAAP financial measures, Reg G requires the company to also present the most directly comparable GAAP measure and a reconciliation of the non-GAAP measure to the comparable GAAP measure. If non-GAAP financial measures are included in a filing with the SEC, under Item 10(e) of Reg S-K, the non-GAAP financial measure must be accompanied by a presentation with equal or greater prominence to the most comparable GAAP measure. Item 10(e) also requires disclosure as to why the non-GAAP measure is useful and how management uses the non-GAAP measure. Among other things, these disclosure requirements are applicable to earnings releases that are furnished to the SEC under Item 2.02 of a Form 8-K.

Non-GAAP measures are one of the more frequent areas of comment for the SEC, and many of the comments address undue prominence concerns. Although enforcement actions in this area have been rare, the SEC recently found that the failure by a company to give equal prominence to the comparable GAAP measures in an earnings release was a violation of the Exchange Act.[6] The plaintiffs bar have taken note of the equal prominence rule and threatened claims alleging that companies who do not give equal prominence to comparable GAAP measures when presenting non-GAAP measures are violating securities laws.

The takeaways are as follows:

1. The SEC is focused on the equal prominence rule and is prepared to take enforcement action, rather than relying on the comment letter process to police violations.
2. Failure to comply with the non-GAAP measure disclosure rules could get the attention of shareholder plaintiffs.
3. Boards should take an active role in overseeing the use of non-GAAP measures in financial reporting. This involves reviewing non-GAAP measures with management, considering common measures used in the industry and assessing their relevance for investors.
4. Audit committee should have policies and procedures in place to ensure that SEC rules are followed and should question management and the company's auditors regarding adjustments made to GAAP numbers. Boards should actively review the presentation of non-GAAP measures and have a full understanding as to why such measures are used and how they are being presented.

[6] *In the Matter of ADT, Inc.* Release No. 84956.