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Directors Under Pressure: So, What Else is New?

Guest and Dorsey Panelists

Peter Carter, Executive Vice President, Chief Legal Officer and Corporate Secretary, Delta Air Lines, Inc.

James Chosy, Senior Executive Vice President and General Counsel, U.S. Bancorp

Dannette Smith, Secretary to the Board of Directors and Senior Deputy General Counsel, UnitedHealth Group Incorporated

Robert Rosenbaum and **Cam Hoang**, Dorsey & Whitney LLP

Program Materials

PowerPoint Presentation

Materials are Available on www.dorsey.com at

<https://www.dorsey.com/newsresources/events/event/2021/11/corporate-counsel-symposium-2021-materials>

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November 9, 2021

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Agenda

- **ESG Moves to the Forefront**
- **DE&I at the Board and in the Workforce**
- **Emerging *Caremark* Board Oversight Risks**
- **Cybersecurity and “Cyber-Governance”**
- **COVID-19 (and Post COVID-19) Board Protocols**

ESG Moves to the Forefront

- **Broadly speaking, ESG matters, particularly around climate change, are among the highest profile issues facing U.S. public companies**
- **Regulators, investors, proxy advisors, activists and others, including employees, are becoming more strident about the need for companies to address various ESG topics, with climate change a particular focus**
- **Ensuring that your Board is aware of the particular ESG topics of most interest to your shareholders is critical**

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ESG Moves to the Forefront

- **High-profile director “vote no” campaigns**
 - **Three directors at Exxon were replaced by activist nominees based on climate change concerns**
 - **The Exxon campaign was led by a new, very small activist investing firm that garnered support from major institutional investors**
 - **Engine No. 1 itself held only 0.02% of Exxon’s outstanding shares**
 - **Normally passive investors, such as Blackrock and Vanguard, supported replacing the three directors**
 - **More active public pension funds, such as CalPERS, CalSTERS and NYS funds, also supported replacing those directors**

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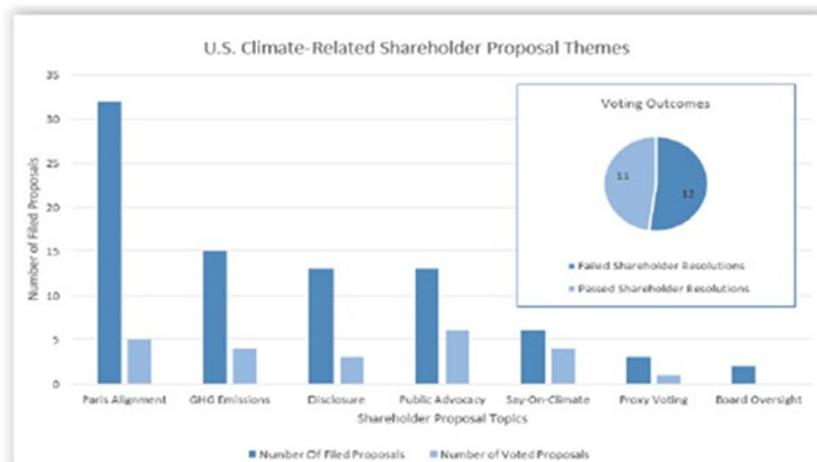
ESG Moves to the Forefront

- And, climate-related shareholder proposals achieved unprecedented success in the 2021 season
 - A proposal requesting an annual report on plastic pellet pollution at DuPont passed with 81% of the votes cast in support (management opposed)
 - GE’s shareholders strongly (98% of votes cast) supported a proposal to report on net-zero greenhouse emission strategies (which proposal had management support)
- Other ESG proposals also did well in 2021
 - DuPont also had a proposal for it to report its EEO-1 data passed with 84% of the votes cast

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ESG Moves to the Forefront



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ESG Moves to the Forefront

- On November 3, 2021, the SEC released new guidance on shareholder proposals rescinding prior guidance
- This relates to the application of the “ordinary business” exception and its “micro-management” consideration that enabled companies to reject numerous shareholder proposals raising E&S concerns
- The new guidance is designed to make it much harder to make use of this exception when “significant social policy” matters are included in proposals, whether or not there’s a nexus to the business
- Board analysis will no longer be expected in connection with a no-action request
- Public companies should expect to see more E&S-focused proposals designed to raise such public policy issues in the future

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ESG Moves to the Forefront

- SEC Chair Gensler has publicly remarked multiple times about the importance of requiring uniform, mandatory disclosure around climate change (as well as human capital and board diversity)
 - The SEC Spring agenda includes climate risk disclosure on its proposed rulemaking activities
- His statement on mandatory climate change disclosure at the PRI event in July 2021 is telling:
 - “Investors today are asking for that ability to compare companies with each other. Generally, I believe it’s with mandatory disclosures that investors can benefit from that consistency and comparability. When disclosures remain voluntary, it can lead to a wide range of inconsistent disclosures.”
 - SEC Chair Gary Gensler on mandatory climate change disclosure Principles for Responsible Investment event in July 2021

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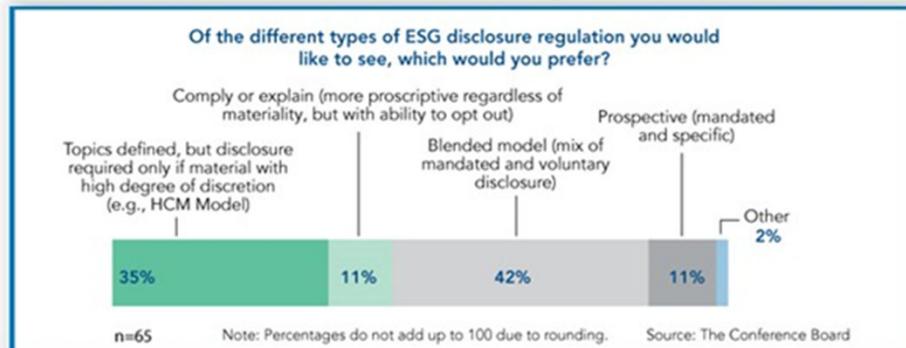
ESG Moves to the Forefront

- Earlier this year, the SEC issued a “sample letter” and sent comment letters to dozens of public companies seeking more MD&A discussion of a number of climate-related topics that it deemed material to the registrant in question
- The SEC is also asking companies to consider adding or modifying risk factors to address the effects of climate change in various areas
- Earlier this year, the SEC’s Enforcement Division announced that it had created a task force focused on climate and ESG matters
 - Its initial focus is stated to be identification of “any material gaps or misstatements in issuer’s disclosure of climate risks under existing rules”

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ESG Moves to the Forefront

The Conference Board asked a working group of over 300 executives from 150 companies about what approach to ESG disclosure regulation they would prefer to see:



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DE&I at the Board and in the Workforce

- **Pressure to add diverse (particularly, racially diverse) board members is continuing to come from many sources: regulators, corporate community, institutional investors, proxy advisors, states and private litigants**
- **State statutes mandating or requiring disclosure of board diversity are proliferating**
 - Adopted in CA, CO, IL, MA, NY, PA and WA
 - Pending in other states
- **SEC approved new Nasdaq board diversity listing rules**
 - Board diversity matrix (effective for 2022)
 - “Comply or explain” board diversity requirements (transition periods beginning in 2023 and depending on listing tiers)

DE&I at the Board and in the Workforce

- **Institutional investors have moved rapidly in the past few years to update their voting guidelines with respect to Board diversity**
 - Blackrock, Vanguard, State Street Global Advisors and Legal & General Investment Management, four of the largest asset managers in the world, all have adopted “vote against” policies
 - Pension funds, including funds under the supervision of the NYC Comptroller have led campaigns advocating diversity at Boards
- **Council of Institutional Investors has publicly supported proposed federal legislation mandating Public company disclosure of Board diversity**
- **Starting with the 2022 proxy season, ISS will recommend voting against at least governance committee chairs of boards with no racially or ethnically diverse members**

DE&I at the Board and in the Workforce

- **Pressure from regulators, institutional investors and employees concerning human capital management issues has resulted in further disclosures**
- **According to Bloomberg, 76 S&P 100 companies have made EEO-1 data available this year, compared to only 25 in 2020**
 - **And, 10 additional companies have pledged to do so in 2022**

DE&I at the Board and in the Workforce

- **As a result of all of the foregoing, companies should expect:**
 - **more demands for detailed diversity disclosures,**
 - **more demands for explanation of board process to improve diversity,**
 - **more shareholder votes against governance committee chairs at boards that lack any racial or ethnically diverse members, and**
 - **more litigation focused on companies not “walking the talk” (*i.e.*, their public reporting does reflect what is really occurring inside their companies)**

Emerging *Caremark* Board Oversight Risks

- Delaware courts established a subsidiary fiduciary duty of directors of “oversight” in the *Caremark* line of cases
- Two kinds of potential *Caremark* oversight failures have developed
 - Failure to implement any board oversight policies
 - Failure to actively monitor policies adopted by the board
- Because these cases involve duty of loyalty claims, directors cannot be exculpated from personal liability, if found to be in breach
- Delaware judges have repeatedly stated that proving a *Caremark* claim is the most difficult fiduciary duty breach to find
 - Because it requires a showing of “bad faith” on the part of directors
- But, a disturbing trend has emerged over the past three years, with DE courts finding potential personal liability for directors

Emerging *Caremark* Board Oversight Risks

- *In re The Boeing Company Derivative Litig.*, (DE Ch. Ct. 9/21): *failure to develop meaningful oversight policies, and failure to monitor*
 - This is one of many cases coming out of the two Boeing 737 MAX crashes in 2018 and 2019
 - Excoriating, heavily detailed, fact-intensive, 100-pg opinion
 - Court found that plaintiffs had sufficiently pled a duty of loyalty breach (*i.e.*, lack of good faith) by directors
 - This was due to the Board’s complete failure to (i) establish an oversight system (and then monitor it) and (ii) their failure to respond to red flags regarding “mission-critical airplane safety”
 - The plaintiffs in the Boeing case drew upon thousands of internal Board documents such as meeting minutes and emails they accessed under Delaware state law

Emerging *Caremark* Board Oversight Risks

- **Key factors noted by the Court included:**
 - Meeting minutes (of both the Board and Audit Committee) did not indicate that directors engaged in rigorous discussions of safety issues in the years when the 737 MAX was being developed
 - The Board had not created a separate committee to monitor airplane safety *until after the 2nd crash*
 - The Board did not cause management to provide regular safety updates
 - Per the Court, the Board “passively” received them at management’s discretion
 - The Board publicly lied about whether and how it monitored 737 MAX’s safety
- **The Court specifically found scienter on the part of the Board, based on a record of their knowledge of shortcomings around safety oversight and their false public statements**
- **5th case in last 3 years to survive motion to dismiss**

Emerging *Caremark* Board Oversight Risks

- **Some take-aways from recent cases:**
 - Establishing a clear process for Board oversight (either at a specific Committee, or through regular and rigorous reporting and discussion at the full Board) of “mission-critical” company issues is fundamental to fulfilling director’s duties
 - Ignoring “red flags” about material risks reported up to the Board is dangerous
 - Maintaining accurate and well-drafted minutes of Board and relevant Committee meetings (and other records) is essential to demonstrate proper oversight and consideration of “red flags”
 - If the record reflects even a decent process, directors will still receive the benefit of the doubt (at least in DE)

Emerging *Caremark* Board Oversight Risks

- **But, Delaware Court of Chancery recently dismissed *Caremark* claims rising from Marriott cybersecurity breach**
 - Hack of up to 500 million guests' personal data in the Starwood reservations system—one of the largest hacks ever
 - Court found that the allegations do not meet the high bar required to state a *Caremark* claim, ie, that:
 - the directors completely failed to undertake their oversight responsibilities,
 - turned a blind eye to known compliance violations, or
 - consciously failed to remediate cybersecurity failures
 - “With hindsight knowledge of the extent of the data breach,” the Board’s remediation plan was implemented “probably too slow.” But, “the difference between a flawed effort and a deliberate failure to act is one of extent and intent. A *Caremark* violation requires the plaintiff to demonstrate the latter”
 - The Court dismissed the plaintiff’s complaint

Fire Ret. Sys. of St. Louis v. Sorenson, et al., 2021 WL 4593777 (Del. Ch. Oct. 5, 2021)

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Cybersecurity and “Cyber-Governance”

- **In a Deloitte survey of 577 C-level executives:**
 - 98% of U.S. organizations experienced at least one cybersecurity event in the past year, compared with 84% among non-U.S. organizations
 - Disruption from COVID-19 led to an increase in cyber threats at 86% of organizations in the U.S., compared with only 63% of non-U.S. entities
 - Yet 14% of U.S. executives said their organization has no defense plan against cyber threats, compared with only 6% of non-U.S. executives
 - 28% of U.S. executives say their biggest concern is the unintended actions of a well-meaning employee, compared to 27% of those concerned with malicious attacks via phishing, malware or ransomware

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Cybersecurity and “Cyber-Governance”

- **Ransomware and other attacks are a daily occurrence throughout Corporate America**
 - December 2020 *Solar Winds* hack had broad effects rippling through the economy, and has caused SEC to request information from 100’s of potentially affected public companies
- **SEC has been increasing its enforcement activity after establishing a separate cyber unit within its Enforcement Division**
 - SEC recently charged two companies related to alleged timely disclosure failures: First American Financial Corp. and others
 - SEC also recently charged 8 firms in 3 separate actions related to failures to develop and/or maintain adequate cybersecurity policies and procedures to protect PII: Cetera, Cambridge and KMS
- **SEC considering mandatory cyber disclosure**

Cybersecurity and “Cyber-Governance”

- **Private lawsuits: alleged Board oversight failures (*i.e.*, *Caremark* claims) with respect to cybersecurity incidents are a ripe source of shareholder derivative actions, with the potential for personal liability of directors**
- **The best defense at the Board level is to have sound processes, policies and procedures that are carefully monitored, discussed, reviewed, updated and, most of all, followed**

Cybersecurity and “Cyber-Governance”

- **Each Board should ensure that it:**
 - has proper Board-level oversight and monitoring procedure in place,
 - has a robust and effective enterprise-wide cybersecurity program (in writing),
 - receives periodic updates from management regarding updates to policies and procedures,
 - understands key risks and management proposed response plan (including potential disclosures and
 - has sufficient expertise at Board level to be effective in foregoing
- **Good documentation in minutes and supporting materials is critical**

COVID-19 (and Post) Board Protocols

- **Managing risk through the Pandemic**
 - Human capital
 - Health and safety
 - Business strategy
 - Cybersecurity
- **Adapting Board processes for a Virtual World**
 - Meetings format and cadence
 - Onboarding of new directors
 - CEO/director evaluation process
 - Timing, structure, logistics of strategy “retreats”
- **Preparing for a return to the Boardroom**