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The Informed Board

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In this issue of *The Informed Board*, we discuss how companies can position themselves as merger reviews grow lengthier and more difficult, and we explain the legal framework for NFTs so directors can provide informed oversight if their companies decide to mint these digital assets.

Other articles suggest ways directors can avoid exposure to the proliferation of shareholder suits alleging inadequate board oversight, and mechanisms companies can employ to limit the regulatory and reputational risks of changing overseas supply chains.

Finally, the latest *Informed Board* podcast addresses the pressure companies feel from employees, investors and other stakeholders to take stands on political and social issues.

Boards and M&A: Playing, and Winning, the Game of Regulatory Risk

– With increasingly aggressive antitrust and foreign investment reviews, directors need to be fully informed about the risks of deals from the beginning of negotiations.

– Boards should insist that management and its advisers conduct a deep analysis of the regulatory risks and map out a variety of possible outcomes and responses.

– Because merger reviews are lasting longer and taking surprising turns, boards need to ensure that managements plan for the unexpected and negotiate terms that protect the parties and the value of the deal.

Boards are regularly called upon to guide management teams in answering the age-old strategic question: build or buy? But the already complex business calculus has become increasingly complicated in the past several years because of stepped up scrutiny of mergers by regulators that has made outcomes less predictable.

One need look no further than the front page to find news of transactions abandoned after governmental challenges. Meanwhile, leaders at the Department of Justice and Federal Trade Commission and other competition authorities have spoken of the need to reconceive antitrust law and have voiced support for aggressive new theories about protecting even potential competition.

Against this backdrop, boards and management teams planning an M&A transaction face increased risks that a deal may not be completed by the contractual deadline, or will fail altogether. Regulators may insist on novel and unacceptable remedies, and the value of a deal may be eroded by delays or harsh remedies.

In order to guide management, directors must be familiar with a toolkit of mitigation strategies. That includes decision-making processes, contractual provisions and tactical approaches to dealing with regulators.

In what follows, readers should bear in mind that the acquirer's perspective and priorities will often differ from the target's.

Trends We Have Observed

In the current regulatory environment, we have seen:

– a heightened interest in "fix it first" remedies, explained below;

– contractual provisions expressly addressing whether the parties are required to litigate to obtain regulatory approvals (and potential "tolling" of the drop-dead date while litigating);

- an increasing need to prepare for litigation in parallel with traditional negotiations over remedies; and
- an increased focus on whether to agree to regulators' requests for extensions of their review deadlines, given that, if the matter is going to be litigated, the parties will want to start as soon as possible.

Pre-Signing Analysis: Evaluate the Risk of a Blocked or Abandoned Transaction

To ensure that the fundamental risk of non-approval is properly assessed and mitigated, boards should focus on pre-signing preparation, careful negotiation of contractual risk-sharing provisions and a flexible post-signing strategy to obtain approvals.

First, the board must insist that management, with the help of outside advisers, conducts a probing analysis that goes well beyond traditional competition measures such as horizontal overlaps and combined market shares, which might have sufficed in the past. The analysis should consider the parties' documents and the expected reactions of customers, suppliers, employees, industry groups and competitors, because those could factor into regulators' decisions.

The parties need to fully understand the relevant authorities' current enforcement priorities, and any novel antitrust doctrines that key officials espouse. In cross-border deals, they will also need to evaluate the impact on national "industrial policy." That will include any connection to highly sensitive or favored industries and other policy goals that regulators may pursue as part of their review. Today those could include climate change, data privacy, employment and even wealth distribution.

Given the more aggressive positions that regulators are taking, thought also needs to be given at this stage to the circumstances in which it will make sense to litigate over the approval.

The analysis and its conclusions should be summarized and presented to the board, with ample opportunity for directors to raise questions and request follow-up investigation. And boards should continue to be briefed as more is learned throughout the deal process and regulatory issues are negotiated in contractual provisions.

Agreement Terms To Mitigate and Allocate Risk

A variety of established M&A terms can help manage regulatory risks and specify who bears them.

Efforts Covenants

The most familiar of these is the "efforts" covenant, which requires both acquirer and target to work together to obtain regulatory approvals, including by agreeing to divestitures and other remedies.

Sometimes these are "hell or high water" covenants that require the parties to accept all divestitures or remedies that regulators demand, *In order to guide management, directors must be familiar with a toolkit of mitigation strategies. That includes decision-making processes, contractual provisions and tactical approaches to dealing with regulators.*

but, in today's market, those account for less than 10% of these clauses in strategic deals. More often, they are limited by quantitative or materiality thresholds, or sometimes a commitment to divest a specific business or segment. The key is to negotiate a level of commitment that matches the most likely outcomes. This provision will be framed based on the initial analysis of possible scenarios. It's important to keep in mind, too, that even a "hell or high water" commitment does not guarantee consummation of a deal in the face of regulatory opposition.

Reverse Termination Fees

In some situations, the target may agree to a deal even though there is a significant risk that the transaction will not be approved, even with remedies. In these cases, the target may negotiate for a reverse termination fee payable by the acquirer in the event regulatory approvals are not obtained and the transaction fails to close. These fees are intended to mitigate the potential harm the target's business may suffer if the deal fails, and, often more importantly, they provide additional incentive to the acquirer to obtain approvals.

However, while reverse termination fees have ticked up, at a typical 4% to 6% of transaction value (occasionally much more), they may be a poor substitute for completion of the intended transaction. Therefore, even if such a fee is in place, during the review process, target boards will need to keep management focused on protecting against possible harm should the deal fail.

One cautionary note: There is a tendency to go right to the size of the reverse termination fee at the start of M&A discussions. This is not typically the best approach for either the acquirer or target. While important, the size of the reverse termination fee is not the only issue to be negotiated, and often not even the most important one, and issues can be traded off against each other. The best course in any particular deal should be informed by a clear-eyed view at the outset of the potential regulatory risks, and how they might be addressed. Often this requires a preliminary exchange of sensitive, confidential information at the early stages of the talks, which can of course be in tension with other tactical and strategic considerations.

Preemptive Divestitures

To head off problems with regulators, the parties can agree to exclude assets that raise competition issues for the transaction. For instance, where something less than a whole company is being purchased, the seller might agree to retain the problematic asset. In transactions involving a whole company, the parties may agree to a "fix it first" strategy, divesting a business or asset to a third party at or near the time they sign the main agreement. These can resolve regulators' concerns early and shorten the time it takes to obtain approvals.

Timing Provisions

With extended reviews, companies need to provide for the possibility that approval may take longer than hoped for. Boards should therefore guide management to set longer deadlines and ensure that there are mechanisms in place to deal with the possibility of extended delays. They should also query management about the impact of delays on the value of the deal.

In recent deals, these issues have been addressed with mechanisms such as:

– longer outside dates for completion and provisions for extensions;

– "ticking fees" paid by the acquirer in exchange for extending the initial outside date for the primary transaction (these function like interest payments);

– an increase in the reverse termination fee if the acquirer elects to extend the outside date or requires the target to agree to a divestiture in order to secure regulatory approval (similar to a ticking fee, but not a "pay as you go" cost to acquirer, and only paid if the deal terminates);

– if legally permissible, loans from acquirer to the target that are forgiven if the primary transaction does not close;

– expanded reimbursement for the target's costs to negotiate and consummate a divestiture; and

– additional employee retention funds for the target if the deal does not close within certain time periods, typically shouldered by the target but sometimes reimbursed by the acquirer.

Providing for delays in the merger agreement can help avoid a situation where party seeks to renegotiate terms if the deal drags out longer than expected.

Express Covenants To Litigate

Increasingly, antitrust authorities across jurisdictions have turned to litigation to challenge transactions, even where remedies have been offered by the parties. Therefore, both parties' boards are well served to guide management to seek provisions that clearly spell out when the parties are obligated to pursue litigation if regulators refuse to approve a transaction. Without these clear provisions, the parties may find themselves disputing the meaning of the more general efforts covenants as it relates to litigation.

Protecting the Benefit of the Deal

Differing Viewpoints on Safeguarding Value

Both parties and their boards should be focused on protecting the benefit of the deal, but they will benefit in different ways, and hence their approaches to obtaining approval may differ.

Acquirers will likely be most concerned about (a) being forced to make divestitures at valuation multiples lower than that of the primary transaction, (b) maximizing synergy opportunities, and (c) protecting the acquirer's existing platform — for example, by resisting consent decrees that would require it to seek prior approval for all future transactions in the sector, regardless of transaction size. (FTC officials have said they will routinely seek to impose such conditions.) Acquirer boards should help guide management to address these.

For a target, however, obtaining payment of the full negotiated deal price will be paramount, and with as little delay as possible. The target board should help to keep management focused on that end.

As a result, acquirers typically are more willing to take time to convince regulators that minimal or no remedies should be required, while the target often will want the acquirer to offer as much as possible as soon as possible. This inherent tension makes it particularly important to negotiate provisions covering who ultimately controls the regulatory process.

Managing the Divestiture Process

When a party is forced to divest assets, or that becomes likely, it may find itself in a weak bargaining position. Perceived bargaining power generally declines as the review process advances and potential bidders become aware of each other's identities and credibility.

As we mentioned above, one way to address that is through a "fix it first," or preemptive, sale arranged before a remedy package has been formalized. That allows an auction to be run with more secrecy and perceived competition.

Of course, the regulators' requirements cannot always be anticipated, and different jurisdictions may ultimately require different concessions, so there is a significant risk of a mismatch between the package marketed and what merger authorities ultimately require. That can sometimes be addressed with "accordion" options, which give the divestiture seller the right to add additional assets into the package at an agreed price.

If the target is making the divestiture, it may want to condition the sale on completion of the primary deal so it retains the asset if the larger transaction fails. But bidders may offer less if the sale is conditional, and if the sale involves an operating business and not just an asset, an extended period of uncertainty could cost the business customers or employees. That could exacerbate the damage to the target if the primary transaction falls through.

If the divestiture is not conditioned on the primary deal closing, the price may improve, but it still may fall short of what the seller would have required absent the overarching benefit of the primary transaction.

Given the impact the divestiture process can have on the value of an overall transaction, boards on both sides should request frequent updates from management as the process unfolds. These updates should include quantitative analysis of the impact of a contemplated divestiture, including the effect on synergies in the overall transaction.

In Their Own Words: Regulators' New Focuses and Priorities

Federal Trade Commission Chair Lina M. Khan articulated the new priorities of her agency in January 2022 when it solicited comments regarding changes to its merger guidelines:

- "While the current merger boom has delivered massive fees for investment banks, evidence suggests that many Americans historically have lost out, with diminished opportunity, higher prices, lower wages, and lagging innovation. . . ."
- "[A]re the guidelines adequately attentive to the range of business strategies and incentives that might drive acquisitions, be it moat-building or data-aggregation strategies by digital platforms, or roll-up plays by private equity firms? More broadly, how should the guidelines analyze whether a merger may 'tend to create a monopoly,' including in its incipiency. . . ."
- "[D]o the guidelines adequately assess whether mergers may lessen competition in labor markets, thereby harming workers? Are there factors beyond wages, salaries, and financial compensation that the guidelines should consider when determining anticompetitive effects? And when a merger is expected to generate cost savings through layoffs or reduction of capacity, should the guidelines treat this elimination of jobs or capacity as cognizable 'efficiencies'?"

(Continued on page 7)

Interim Operating Covenants

Target boards will also need to ask if there should be some flexibility in the target's interim operating covenants, which regulate the target's business while the deal is pending. Restrictions that may be tolerable for nine to 12 months may be untenable over 15 or 24 months. Targets should not be forced to choose between complying with the covenants and harming their business. In addition, targets will be wary of potentially committing a "foot fault" under interim operating covenant at the very time when the deal may be in jeopardy and in extended regulatory review.

Acquirer's boards, meanwhile, should guide management to consider which interim operating covenants are truly critical to protecting the value of the target business regardless of timing.

Control of Strategy and Documenting Disagreements

Where the acquirer agrees to accept all or some of the antitrust risk, most merger agreements give the acquirer express control over strategy decisions. Often there is an escalation process involving senior management if the target disagrees with the acquirer's approach.

Target boards, in particular, should strongly consider overseeing management closely to ensure it is following the escalation process and documenting any objections to the acquirer's strategy. This may lead to awkward interactions between the two companies' senior executives (the acquirer representative may ultimately "overrule" the target representative), but if target management remains silent or acquiesces to the acquirer's strategy without objecting through the formal process, it may compromise the target's ability to argue later that the acquirer's decisions violated its efforts covenant. Failing to document objections may, in some cases, affect the availability of termination rights and reverse termination fees.

In Their Own Words: Regulators' New Focuses and Priorities

(continued from page 6)

Jonathan Kanter, head of the Department of Justice's Antitrust Division, spoke of the new, more assertive approach of his unit in remarks delivered at a conference on September 13, 2022:

- "In many sectors, just one or two powerful companies dominate. In many others, rampant oligopoly behavior deprives consumers and workers of the benefits of robust competition. We see this in higher consumer prices, lower wages and fewer new businesses being created. At the same time, we see it reflected in corporate control over the flow of information and public discourse."
- "We are litigating more than we have in decades. Since I was confirmed in November, the Division has challenged or obtained merger abandonments in six cases. Several other transactions were abandoned after parties were informed they would receive second requests."
- "[M]erger enforcement has become disconnected from the competitive realities of our economy. It has become a sometimes-artificial exercise. We focus too much on a small handful of models for predicting price effects, and lose sight of the competition actually at stake. We obsess in all cases about market definition, when in many situations direct evidence can help us assess the potential for harm."

Conclusion

With challenging new dimensions to the merger approval process and amplified risks, directors need to take an active role in overseeing the negotiation and progress of mergers. They should (a) insist at the outset on penetrating assessments of the regulatory risks, (b) help guide management in formulating regulatory strategy and risk mitigation, (c) monitor progress with the deal's outside date in mind; and (d) be prepared for litigation with regulators.

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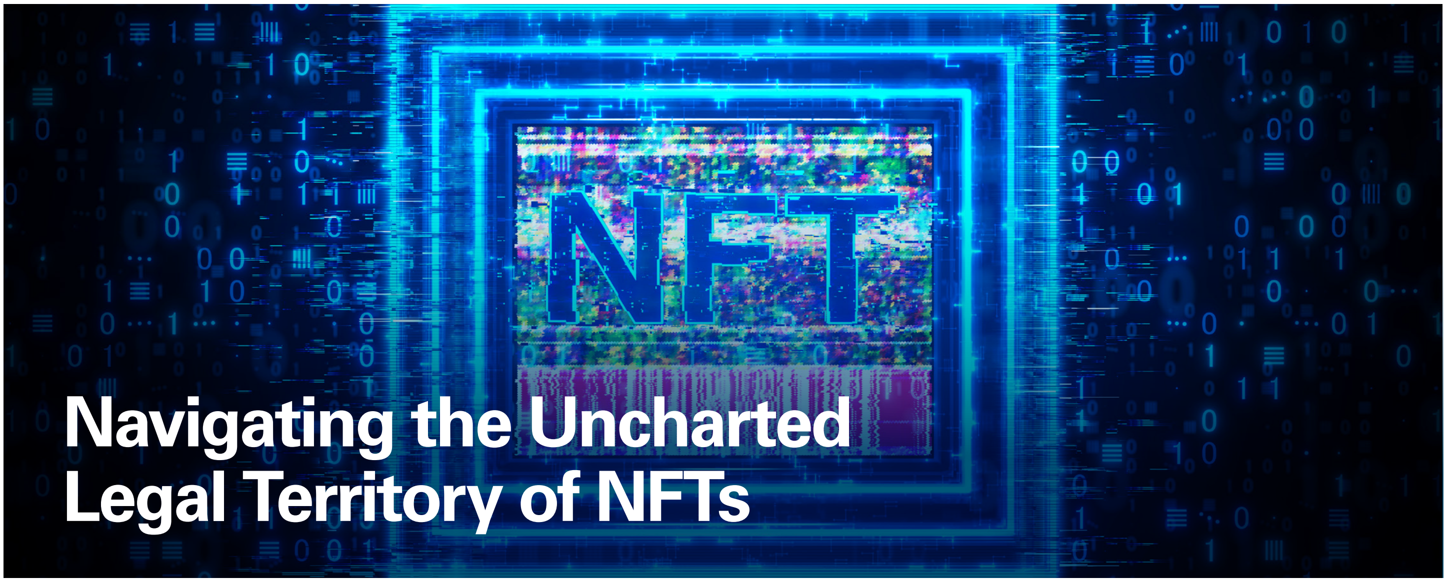

Navigating the Uncharted Legal Territory of NFTs

- Many businesses are exploring NFTs as a way to capitalize on intellectual property and reinforce relationships with fans and customers.
- Those weighing whether to "mint" NFTs need to look closely at existing agreements, which may not clearly address who has the right to create an NFT. There is already some litigation over the issue.
- Creators should also be aware that, if an NFT is marketed as an investment, it may fall under the securities laws, and trading NFTs based on inside information may be illegal in some circumstances.

Over the last two years, non-fungible tokens, commonly known as NFTs, have entered the mainstream as global brands, entertainment companies, sports leagues and others have created (or "minted") NFTs of a variety of digital works, in many cases attached to "real world" benefits.

If your company is presented with an opportunity to take advantage of NFTs, you will need to understand in broad terms what NFTs are, the existing legal framework surrounding them and the unresolved legal issues they pose.

What Is an NFT?

To understand NFTs, one has to start with blockchain technology. A blockchain is a peer-to-peer decentralized network of computers that allows transactions to be validated and then transparently recorded in a master ledger. Importantly, there is not a single blockchain; rather, there are multiple blockchains, not all of which can interact with one another.

Because each new block of transactions on a blockchain is cryptographically based on the previous ones, blockchains are immutable; for all practical purposes, records cannot be altered. Blockchains therefore provide a powerful technology to create and perpetually store immutable records of the ownership of digital goods.

These ownership records are NFTs, each of which have a pointer to the specific digital good they represent. That distinguishes them from other types of digital assets on a blockchain, such as cryptocurrencies, which are all the same — *i.e.*, fungible.

A key feature of NFTs is that, despite the term "token," they are in fact programmable pieces of computer code. This allows developers to design an NFT that, for example, pays royalties automatically every time an NFT is sold.

How Are NFTs Being Used Commercially?

Although we are at the nascent stages of the evolution of NFTs, as creators and rights holders explore how to exploit this technology, NFTs have already been put to use by a number of different types of business:

Digital art and music. In their simplest form, NFTs can be associated with digital creative works, such as art or music. NFTs allow creators to market their works to, and engage directly with, fans, who can use the NFTs to signify that they own an official copy of a work and not a digital copy.

Brand-driven NFTs. Global brands have embraced NFTs as a means to engage with their consumer bases. In these cases, NFTs are often collectibles that also "reward" consumers with access to benefits or promote new products or services. For example, Coca-Cola auctioned NFTs that were virtual images of iconic Coca-Cola merchandise, such as a virtual custom-designed Coca-Cola Bubble Jacket. Proceeds from the auction went to Special Olympics International.

Fan engagement. Traditional intellectual property rights holders, including entertainment companies and sports leagues, are using NFTs to create and market digital collectibles as a means to build fan engagement for both existing and new fans. For example, the National Basketball Association and Disney have each released a number of different types of collectible NFTs to engage with their respective fans.

Gaming. Gaming companies are looking at ways NFTs can be used to allow players to own in-game assets, such as "skins" a character might wear, and potentially trade them or transfer them to other games.

Future uses. There are also experiments using NFTs as a source identifier for both tangible and intangible goods and services. This might include school transcripts and professional certificates; proof of identity; and ways to record ownership of specific tangible assets. For example, BlockBar sells collectible liquors and wines obtained directly from producers and mints NFTs that correspond to a specific bottle stored with BlockBar, assuring authenticity and allowing the owner to take delivery or sell the bottle.

Legal Issues Presented by NFTs

Businesses considering NFT opportunities need to understand the existing framework of intellectual property law that applies to them, and the fact that there are certain unresolved legal questions surrounding them. Here are just a few of them, and we limit our discussion here to U.S. law.

Who Has the Right To Mint an NFT?

Anyone minting an NFT needs to determine whether they have the appropriate rights to the underlying

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digital work. Given that NFTs have only recently come into use, most existing contracts involving the creation of, and rights to, digital goods make no reference to NFT rights. Therefore, for the time being, to assess who has the right to mint an NFT one must rely on a standard intellectual property analysis, and also examine existing agreements to see if there are clauses that could be construed to encompass NFTs. Already, there has been some litigation over who has the right to mint certain NFTs. For example, the director Quentin Tarantino is in litigation with Miramax over his right to mint NFTs consisting of digital images of portions of the handwritten version of the *Pulp Fiction* screenplay.

What Rights Are Being Acquired in the Underlying Work?

The purchaser of an NFT does not normally acquire intellectual property rights and, in particular, copyright rights, in the associated work. In this respect, purchasing an NFT is no different from purchasing a piece of physical art. Just because you bought a David Hockney painting does not mean he can't paint another identical painting and sell it to someone else. While the buyer of a painting owns the physical work, they typically do not acquire any intellectual property rights in the work itself.

While most NFT issuers only grant purchasers the right to use and display the work underlying the NFT for personal use, some issuers are starting to grant limited or broad commercial rights allowing purchasers to exploit their work.

It is important to draft NFT license agreements to define carefully the rights the issuer wants to grant, and to make sure those terms are binding on all subsequent purchasers.

Which Jurisdiction's Laws Apply?

All legal issues surrounding NFTs are complicated by the fact that it may not even be clear which jurisdiction's laws should apply. One must factor in that NFTs are offered on a decentralized blockchain ecosystem, and are paid for in cryptocurrencies and can be effectuated without either party revealing any geographic-identifying information such as a shipping or billing address. As the use of NFTs and blockchain technology expands, in the U.S., we expect it will take a series of court decisions to establish a framework for resolving these issues.

Could the NFT Be Considered a Security?

Those who offer, sell or purchase NFTs need to be attuned to potential securities law issues. Under the Supreme Court's so-called "*Howey* test," an "investment contract" (and thus a security) exists where there is

(1) an investment of money, (2) in a common enterprise, (3) where profits are reasonably expected to be derived from the managerial or entrepreneurial efforts of others. The doctrine takes its name from a 1946 Supreme Court decision interpreting securities statutes from 1933 and 1934, long before the existence of the internet, blockchains and NFTs, but the legal standard remains the same.

Courts have held that an asset may not be an investment contract when it is acquired primarily for personal use rather than as a passive investment. Moreover, where the profits sought by purchasers are based on their own efforts or market forces of supply and demand, the asset may not be treated as a security.

In practice, this means the determination is very fact- and circumstance-specific, so each potential NFT transaction will need to be assessed to determine if the investment contract criteria might apply.

Most cases involving the *Howey* test have involved underlying assets that are not securities. But in deciding if there was a reasonable expectation of profits based on the managerial efforts of others (*i.e.*, the creator or promoter), courts have also looked to the manner in which the underlying asset is promoted to purchasers — including any promises made by the seller. Companies will therefore need to consider not just the NFT itself but all the circumstances surrounding its offer and sale.

The Risk of Insider Trading Issues

Businesses considering involvement in the NFT market also need to be aware of the risk of insider trading in NFTs, which was highlighted by several recent prosecutions and enforcement actions. Companies may want to create NFT trading policies to head off potential problems.

On June 1, 2022, Nathaniel Chastain, a former project manager at the largest NFT marketplace, OpenSea, was arrested on federal charges of wire fraud and money laundering. According to the indictment, Chastain used confidential information he learned in his job about which NFTs would be featured on OpenSea's homepage. He then allegedly bought those NFTs, knowing they would likely rise in price when featured, and sold them for a profit. The prosecutor stated that Chastain's arrest "demonstrate[s] the commitment of this office to stamping out insider trading — whether it occurs on the stock market or the blockchain."

Similarly, on July 21, 2022, the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) each brought insider trading charges against a former Coinbase product manager, his brother, and a close friend for using material non-public information to purchase a variety of non-NFT cryptoassets prior to announcements by Coinbase that these assets would be listed on the company's cryptocurrency trading platform.

While the SEC's claims alleged that the traded digital assets were securities, the DOJ's charges did not because, like the OpenSea charges, they were based on alleged violations of the wire fraud statutes.

These cases underscore that those dealing with NFTs may possess confidential information that affects the value of an NFT, and that trading on such information could be unlawful. Accordingly, companies that issue NFTs or are involved in any activity that could affect the value of an NFT should consider implementing NFT trading policies. Even if the liability risk to the company itself (as opposed to its employees) may be low, companies could nevertheless face reputational harm if an employee engages in wire or securities fraud by trading NFTs based on the company's confidential information.

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'Mission Critical' Issues and 'Red Flags': What It Means for a Board To Exercise Oversight

- Delaware courts have become more willing to allow stockholders to pursue claims that directors breached their duty to oversee risk management and compliance.
- Directors are most vulnerable to suits where they have not established oversight processes for monitoring risks in "mission critical" aspects of the business or where "red flags" arguably should have alerted the board to looming problems.
- Boards need to ensure that they are devoting enough attention to risks and compliance and carefully document their oversight efforts.

Directors' fiduciary duty of loyalty to the company and its stockholders includes a duty to oversee the company's operations. That, in turn, includes an obligation to take reasonable measures to implement and oversee risk management and compliance controls. Where a board fails to do this, directors may be vulnerable to lawsuits by stockholders. In Delaware, whose law governs most large American corporations, these are known as *Caremark* claims.

Historically, these kinds of suits have been very difficult to maintain because they require that plaintiffs show bad faith on the board's part. And a bad outcome does not suffice to show bad faith.

Nonetheless, over the past several years, Delaware courts have allowed an increasing number of *Caremark* claims to survive a motion to dismiss and proceed to discovery. In these cases, the stockholder plaintiff adequately alleged a lack of corporate control systems or the existence of "red flags" suggesting improper oversight. As a recent decision put it, *Caremark* claims, "once rarities … have in recent years bloomed like dandelions after a warm spring rain."

Boards need to take these recent rulings into account in considering how to oversee their companies' risk management and compliance.

What the Duty of Oversight Entails

The 1996 *Caremark* case that gave its name to these claims held that a director's duty of loyalty requires directors to implement and monitor risk oversight processes. To prevail in a suit against directors for breach of this duty, a plaintiff must prove that directors were not just negligent, but acted in bad faith — that they either (a) "utterly failed to implement any reporting or information system or controls" (the "first prong") or (b) "having implemented such a system or controls, … consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention" (the "second prong").

Bad faith requires that directors intended to do harm, consciously disregarded their responsibilities or failed to act in the face of a known duty to do so.

That is a high hurdle for plaintiffs, and no *Caremark* claim has ever even gone to trial. But in recent years stockholders have utilized their rights to inspect corporate books and records more frequently, and in a growing number of *Caremark* cases, they have drawn on that internal information to allege bad faith with enough detail to survive a motion to dismiss.

Delegate Responsibility to Management But Exercise Oversight

Delaware law recognizes that directors are not involved in the day-to-day management of their companies and protects them when they rely in good faith on information provided by officers and employees, among others. However, the board still has to be involved, and must take reasonable steps to establish a compliance system (the first prong of *Caremark*) and then must monitor that system (the second prong). "*Caremark* envisions some degree of board-level monitoring system, not blind deference to and complete dependence on management," as one Delaware decision put it recently.

Just where to draw that line is the issue at the core of recent *Caremark* cases, as we will explain.

Inadequate Control Systems (First Prong)

In several recent suits, the stockholder plaintiff was allowed to proceed with its claims where it alleged in some detail that a board acted in bad faith and violated its duty of oversight by failing to establish a committee or other system to monitor "mission critical" risks at the board level in monoline companies. For example:

- An ice cream company's board faced potential *Caremark* liability after a listeria outbreak, when a stockholder plaintiff alleged that directors failed to implement any system to monitor the company's food safety performance or compliance.
- An oversight claim against Boeing's board relating to the 2018 and 2019 crashes of the company's newly-released 737 MAX aircraft survived a motion to dismiss. There the plaintiff alleged that the board did not monitor, discuss or address airplane safety on a regular basis; had no process or protocols for receiving safety updates from management; never received information on red flags observed by management; and made statements suggesting an awareness of the need for such safety-monitoring systems and procedures.

By contrast, cases have been dismissed where there was a record of conscientious board oversight:

- In June 2022, the Delaware Court of Chancery dismissed *Caremark* claims where a board formed a committee "to oversee and report on safety policies, practices, and performance" that met five times a year to receive "extensive reports" from senior management, and safety risks were regularly reported to the board.

- *Caremark* claims were dismissed in another case when the board received annual risk assessment reports, its audit committee was "routinely apprised" of cyber-security risks and the company engaged outside consultants and auditors to address its risk profile.

Again, a bad outcome does not demonstrate bad faith. Delaware courts have acknowledged that "the directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both." Instead, the legal question is "whether the board made a good faith effort to put in place a reasonable board-level system."

"Red Flags" (Second Prong)

The second way that a plaintiff can adequately plead a *Caremark* claim is to allege that a company's board ignored specific "red flags" that suggested misconduct or malfeasance at the company.

- The Boeing case provides a particularly salient example. There the court found that the crash was a clear "red flag," but "rather than investigating the safety of the aircraft and the adequacy of the certification process," the board "treated the crash as an 'anomaly,' a public relations problem, and a litigation risk."

- In another recent case that the court refused to dismiss, a stockholder plaintiff alleged that a pharmaceutical company's directors knew that management was incorrectly reporting results from a critical clinical trial. The court cited the fact that the board included industry experts who were familiar with regulatory requirements governing the drug trial.

Other examples of "red flags" have included lawsuits alleging illegal corporate conduct, known compliance issues regarding regulations or internal protocols, and employee reports suggestive of risks or deficiencies inherent to the company's operations. In one recent case, the Court of Chancery suggested that the board should also monitor and consider "red flags" from sources outside the company, such as a stockholder's litigation demand letter.

Even with some evidence of "red flags" that were not identified as such, it can be an uphill struggle for plaintiffs. The board must have "consciously overlooked or failed to address them." And not every indication of a potential problem is a "red flag" worthy of a board-level reaction.

- In one recent case, a board was informed that the Federal Trade Commission had opened an investigation into consumer complaints, and the board was aware that the frequency of such complaints had increased. But the court found that this was not a "red flag" that put the board on notice of illegal activity, because the complaints and investigation did not establish that the company had violated consumer protection laws.

- *Caremark* claims were dismissed in another case where the board was aware of litigation alleging that the company had broken the law, but determined in good faith to "allow the ... litigation to play out prior to making any determinations regarding the remediation of the underlying alleged illegal conduct."

Fulfilling the Board's Oversight Obligations

It is hard to draw clear-cut rules based on the litigation to date. But they point to steps boards can take to reduce the risk of a *Caremark* claim, or at least to be positioned to knock out a complaint on a motion to dismiss instead of being subjected to the time-consuming and expensive process of discovery and trial.

- Take good-faith steps to establish monitoring and compliance systems and pay ongoing attention to them. This might require consultation with legal counsel and other experts to identify where risks may arise and how best to monitor them.

- Pay particular attention to "mission critical" issues. This might involve providing for regular reports into such issues, or setting up a board committee empowered to monitor the company's most material risks and regularly report to the full board.

- Discuss with advisers the issues on which the board should receive regular reports and identify what "red flags" may be for the particular business.

- Given stockholders' increasingly frequent demands to inspect corporate books and records, boards should document their efforts in sufficient detail to demonstrate the attention they have paid to understanding and overseeing risk and compliance systems and responding to any issues that arise.

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Avoiding Potential Pitfalls When Developing Alternative Supply Chains

- With ongoing supply chain disruptions and uncertainty, companies continue to consider diversifying their sources for key supplies and inputs.
- Altering supply chains can bring new legal and regulatory risks, including potential sanctions violations and exposure to bribery demands.
- Directors should ensure that their companies are proactive in assessing the risks of new supply chain participants and that their compliance programs are designed to address supply chain-related misconduct.

Companies are rethinking their supply chains in response to geopolitical, economic and environmental developments. Fallout from Russia's invasion of Ukraine (in the form of economic sanctions), COVID lockdowns, shipping disruptions, climate change, and environmental, social and governance (ESG) concerns have shown that reliance on single sources for supplies can create significant risk for companies. Bank of America found that references to supply chain issues in earnings calls increased 412% from Q1 to Q3 2021.

With uncertainty and potential for disruption likely to remain high for the foreseeable future, it makes sense to diversify sourcing for key supplies. However, that entails working with new suppliers, often in new geographic regions. That, in turn, gives rise to regulatory risks.

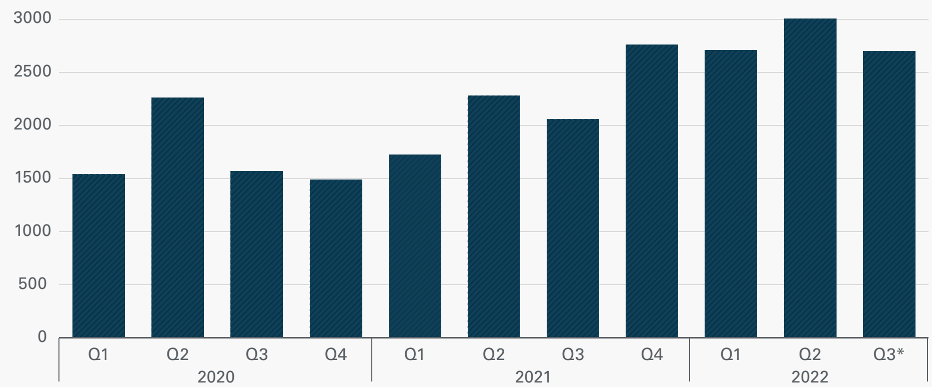
Switching Sources Carries Regulatory Risks

Economic sanctions: Sanctions may have encouraged diversification, but they also complicate the process of finding new suppliers.

The U.S., EU, U.K. and other countries responded to Russia's invasion of Ukraine with financial and trade-related restrictions. The broad scope of these has caused significant disruption in supply chains, particularly in the energy sector, as a result of restrictions on purchases from Russian producers of materials such as aluminum, copper, nickel, palladium, petroleum and platinum.

Inconsistencies across different jurisdictions' sanctions programs has made compliance particularly complex. Understanding to whom

'Supply Chain' Mentions in Corporate Transcripts



Source: Capital IQ

Includes earning calls, analyst calls, M&A calls and conference presentations for U.S. companies

*Projection based on figure to Sept. 13

sanctions apply is critical. It does not suffice to check names on a country's designated persons list. For example, U.K. restrictions can apply broadly to "persons connected with Russia." The risk here is amplified because liability can attach even if the violation is not willful.

It's critical that companies have strong sanctions compliance programs and that new commercial suppliers are screened effectively to ensure that they are located in regions that are not subject to sanctions and that the suppliers themselves are not subject to economic sanctions.

Anti-bribery and corruption measures: New supplier relationships may require import and export licenses and touch points with tax authorities or other government actors, and when companies interact with governments, there is bribery and corruption risk. Well-resourced U.S. regulators have a track record of investigating and enforcing the U.S. Foreign Corrupt Practices Act, and the U.K. Bribery Act creates a broad corporate offence for failing to prevent an associated party from committing bribery. Strong compliance programs can help prevent misconduct and can help companies to identify and correct misconduct where it occurs.

Tax evasion: New supply chains can also bring tax risks. Regulators in the U.S. and U.K. have examined supply chain structures for tax evasion. From 2004-2007, a heavy-equipment manufacturer faced scrutiny from U.S. regulators, who alleged that the company was able to reduce its taxes by $2.4 billion as a result of tax planning related to its supply chain. The investigation led to raids on the company's offices, and the Internal Revenue Service ultimately sought $2.3 billion in payments from the company.

Companies subject to the U.K. Criminal Finances Act also need to assess their tax evasion risks and maintain appropriate policies to manage the risk of committing the corporate offence of failing to prevent the facilitation of tax evasion. U.K. tax authorities are known to visit large businesses to evaluate their prevention procedures related to supply chains.

Environmental, social and corporate governance (ESG) issues: Boards should also be cognizant of economic and reputational risk from failing to maintain adequate ESG standards. In supply chains, forced labor and human trafficking have gained significant attention. In June 2022, the Uyghur Forced Labor Prevention Act came into effect in the U.S., creating a presumption that goods produced in the Xinjiang Uyghur Autonomous Region of China, or with labor linked to specified Chinese government-sponsored labor programs, are produced using forced labor and thus prohibited from entry to the United States.

The U.S. law creates new reporting requirements for companies and forces companies to evaluate their supply chains for any connections to the targeted region. The legislation is already affecting supply chains. For example, the U.S. solar industry has had to adapt because the Xinjiang region produces almost half of the world's supply of a crucial component in solar panels.

The potential reputational risk was highlighted, too, by an August 31, 2022, report by the United Nations High Commissioner for Human Rights finding widespread human rights violations in the region.

ESG risk is not limited to forced labor, though. Companies should consider the potential harm that could flow from being linked to a supplier that is tagged with other negative conduct, such environmental misconduct, workplace culture issues or links to authoritarian regimes.

How To Manage These Risks:

Company boards should assure themselves that company management is taking appropriate action to address these potential risks.

Supply chain diligence is critical for each of the risks above. Companies should conduct due diligence to understand:

- who their suppliers are and where they, in turn, source their inputs.
- the direct and indirect ownership and control of your suppliers, in order to assess whether they have connections to sanctioned territories or parties.

They should ensure that appropriate questions are being asked when conducting due diligence on new suppliers/buyers; for example:

- where do they source key products/raw materials?
- who are their distributors and where are they located?
- where will they ultimately ship these goods?
- do they use sustainable business practices?

Conduct appropriate risk assessments:

- For example, in assessing bribery and corruption risk in your supply chain, consider:

- where your supply chains operate and whether any of those areas are high-risk jurisdictions.
- whether your supply chain touches high-risk sectors, such as raw materials extraction.
- whether government-owned companies are involved; for example, you might consider enhanced due diligence measures if a government has interests in upstream suppliers or if government-owned entities are involved in providing licenses.
- how the company uses third-party intermediaries who may act or provide services on the company's behalf.

Assess the strength of your suppliers' due diligence processes by inquiring about:

– each supplier's compliance framework, including policies and training.

– if and how suppliers' employees can report concerns through whistleblower channels.

– the relationship between suppliers and state-owned companies.

– suppliers' previous experience in your sector.

Negotiate for contractual protections to mitigate these risks. These provisions include:

– incorporating your company's anti-corruption policies into suppliers' contracts.

– ensuring suppliers' payment terms are documented in the contract.

– ensuring that compensation is commensurate to the services performed.

Refresh risk assessments periodically to assess the risks posed by each of the factors above.

Ensure strong compliance programs.

– Company compliance programs should be built to include policies, procedures and training for employees around key risks: sanctions, bribery and corruption, and third-party relationships (suppliers, agents, consultants).

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Podcast: **Should Your Company Take a Stand on Political and Social Issues?**

Listen to the podcast

Skadden partners Ann Beth Stebbins and Ki Hong, Joele Frank partner Jamie Moser and the chief people officer of Duck Creek Technologies, Courtney Townsend, discuss the demands companies face to take positions on political and social issues and growing scrutiny of corporate political contributions.

Corporate culture is important to today's work force, and employees often expect their employers to speak out on political and social issues that are important to them. Employees are also increasingly aware of a company's political contributions.

Understanding employee perspectives on issues that are important to them is vital, says Townsend. Management can stay in touch with the employee base through surveys, round tables or on-to-one conversations, for example. What is important to employees has become important to the business.

It is increasingly difficult for a company to avoid weighing in on political and social issues, even if those issues do not directly affect its operations. But a company needs to have a policy to guide decisions about which issues it will address.

Four factors are driving the pressure from employees, says Joele Frank partner Jamie Moser. First, a new generation of workers wants to produce and consume products and work in an environment aligned with their values. Second, social media has increased the visibility of political and social issues and made the need to respond seem more urgent. Third, political polarization has intensified the emotions around issues. Finally, the rise in importance of ESG factors across society has heightened employee interest in such matters.

When it comes to political donations, scrutiny has increased dramatically since 2015, Hong says. Companies therefore need to balance the views of stakeholders with the consequences of making contributions and taking positions on controversial issues. He notes that taking positions on social and political issues, if not carefully thought through, could cause the company to lose business.

Moser and Hong emphasize that businesses need to anticipate the types of issues on which they may be asked to take a position and decide which issues warrant a public position and which do not. Advance planning is essential. You do not want to be formulating your strategy in the middle of a media storm, they stress.

Sometimes responding to a political issue requires a company to first research logistical questions, Moser points out. That was true when the U.S. Supreme Court delivered its decision in the Dobbs case regarding abortion rights. Companies had to sort out insurance and various legal questions before responding to employees' concerns about the decision's impact on them. In such circumstances, to maintain credibility, leadership should communicate that the company is addressing the issue and, if possible, how the company is approaching the matter even if it cannot immediately provide answers, Moser advises.

Companies can face very different business consequences for their positions on political and social issues depending on the jurisdiction, Hong notes. For example, Texas passed a law barring the state from doing business with companies that take positions in opposition to fossil fuels, and Cook County, Illinois may require its vendors to offer abortion coverage to their employees.

On any given issue, satisfying all stakeholders may not be possible, Hong warns.

Related to these issues, directors who come up for election soon could find more attention being paid to them as individuals — not just as members of a slate — because of the introduction this proxy season of the "universal proxy card" , making it easier for shareholders to choose individual directors, Moser explains. That could lead activists and others to conduct research on the statements and political contributions of directors, in an effort to challenge their board candidacy.

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