2020 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

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ABOUT THIS REPORT

The *2020 Governance Outlook: Projections on Emerging Board Matters* is designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2020, and follows with eight partner contributions that provide distinct insights and projections on the following themes: preparing for the next recession, strategic business risks, regulatory changes, legal risks, board composition, the digital frontier, ESG and engagement, and water scarcity risk.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2019, and (3) relevant implications and questions for boards to consider. The *2020 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2020 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

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Board Oversight in 2020:

"Mission Critical" Risks Become Mission Critical for Directors

By Adé Heyliger, Ellen Odoner, and Aabha Sharma, Weil, Gotshal & Manges

The *Caremark* case[1] set a very high bar for holding directors personally liable for failing to properly oversee their company's affairs. Cases alleging that boards have breached their oversight duty in the wake of a wide range of "corporate traumas"—and even tragedies—generally have not survived motions to dismiss. As boards refresh their oversight agendas for 2020, there are useful lessons to be drawn from two decisions of the Delaware courts issued earlier this year that allowed *Caremark* claims to proceed beyond the motion-to-dismiss stage. Against the backdrop of growing investor demand for board oversight of environmental, social, and governance (ESG) related risks and a widening vision of "corporate purpose," these decisions highlight once again how important it is for boards to

- take a fresh look at identifying their company's "mission critical" risks;
- ensure the company's reporting system elevates information about these risks not only to management but also to the board itself in a timely, actionable way;
- document how the board pays attention to these risks; and
- respond appropriately as a board when the reporting system raises red flags.

Key Projections

1. Boards Will Face Heightened Expectations to Zero in on "Mission Critical" Risks

While directors are not expected to be *omniscient* about each and every risk a company may face, the well-known *Caremark* case made clear that directors are expected to put in place and monitor reporting systems reasonably designed to provide the board with timely, accurate information sufficient to enable it to stay on top of, and make informed judgments about, key risks to legal compliance and business performance. At the same time, claims that boards have not lived up to their *Caremark* duty are described as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[2] In order to prevail, a plaintiff must show that directors acted in bad faith—that they "utterly failed" to implement a board-level reporting system or, having done so, that they "consciously failed" to monitor it.

1. *In re Caremark Int'l., Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).
2. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

In *Marchand v. Barnhill*,[3] the Delaware Supreme Court took the unusual step of allowing a *Caremark* claim to proceed. A stockholder of Blue Bell Creameries alleged that the board had breached its oversight duty where, as a result of *listeria* contamination, three people died from eating Blue Bell ice cream, and Blue Bell was forced to recall all of its products, shut down its plants, and accept a dilutive private-equity investment to address a liquidity crisis. The Delaware Court of Chancery dismissed the plaintiff's claim that the board had "utterly failed" to implement a reporting system—the first prong of the *Caremark* duty—citing evidence of Blue Bell's compliance with FDA regulations, third-party testing, and reporting by senior management to the board on "operational issues." In a unanimous reversal, the Delaware Supreme Court stated that, as a monoline company, food safety was "intrinsically critical" to the operation of Blue Bell's business. The Court found that the plaintiff had met his pleading burden based on the following indicia that there was no system at the *board level* for monitoring this critical risk:

- There was *no* board committee with responsibility for food safety.
- There was *no* regular process or protocol requiring management to report to the board on food-safety compliance and risks.
- There was *no* regular schedule for the board to consider the issue of safety compliance.
- The minutes did *not* clearly show that the board had discussed food-safety issues, even at a time when management was aware of yellow and possibly red flags about contamination at the plants.

Marchand was not a decision on the merits, and the Court was obligated to draw all inferences in a manner favorable to the plaintiff. Nevertheless, the case illustrates that it is important for all boards—not just those of monoline companies—to take the following steps:

- Identify key compliance and operational risks in a common-sense way based on the business of the company.
- Give these risks a regular spot on the board's agenda.
- Establish clear lines of authority and clear protocols for obtaining information and overseeing the management of these risks.

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[3] *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019).

2. Boards in Highly Regulated Industries Should Expect Particularly Strong Scrutiny

Less than four months after the *Marchand* decision, the Delaware Court of Chancery allowed a claim to proceed based upon the second prong of *Caremark*—the board's duty to monitor a reporting system once it has been put in place.[4] A stockholder of Clovis Oncology, a biopharmaceutical company, alleged that the board had consciously ignored red flags that came to its attention about the company's failure to meet regulatory requirements for a clinical trial of its most promising drug and misleading public disclosure about the testing. After these issues came to light, the FDA delayed approval of the drug and the company lost more than $1 billion in market value.

Relying on the *Marchand* analysis, the Court noted that Clovis was a monoline company, the drug in question was a "mission critical" product, and the company was operating in a highly regulated industry. The Court distinguished between a board's oversight of the company's "*management of business risk* that is inherent in its business plan" and (what was at issue in this case) a board's oversight of a company's "*compliance with positive law*—including regulatory mandates."[5] In a cautionary note for directors of companies in highly regulated industries, the Court expressed the view that Delaware courts are more inclined to find *Caremark* oversight liability when the context is a failure of regulatory compliance.

One of the allegations the Court emphasized in *Marchand* was the absence of a board committee with the responsibility for overseeing the mission-critical risk of food safety.

3. Boards Will Refocus on the Effectiveness of Their Oversight Mechanisms

One of the allegations the Court emphasized in *Marchand* was the absence of a board committee with the responsibility for overseeing the mission-critical risk of food safety. We expect that boards will start to take a closer look at the role of their own board committees and either expand the mandate of an existing committee—so, for example, the compensation committee takes on a broader human-capital management oversight role—or, where appropriate, establish a new board committee to oversee a "mission critical" risk to the company. According to Spencer Stuart's 2019 US Board Index, among S&P 500 companies, risk committees are becoming somewhat more common than five years ago, with 12 percent of boards having risk committees, compared with 9 percent in 2014.[6]

Accompanying the expanded use of committees, we anticipate the expansion of "risk mapping." Under this process, responsibility for overseeing key enterprise risks is mapped to the appropriate board committees

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4. *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019).
5. Ibid., p. 12.
6. Spencer Stuart, *Spencer Stuart 2019 US Board Index*, p. 26.

and reflected in their charters. This serves to clarify the oversight responsibilities of each committee and ensure proper oversight of each identified risk. Each committee determines the specific processes and cadence for overseeing the mapped risks and reporting back to the full board.

4. In Focusing on "Mission Critical" Risks, Boards Will Serve the Interests of a Wider Range of Stakeholders

Under Delaware law—and more than 50 percent of all US publicly traded companies are incorporated in Delaware—directors owe their fiduciary duties to the corporation and its stockholders.[7] Recently, with the endorsement of 181 CEOs, the Business Roundtable issued a *Statement on the Purpose of a Corporation* that pledges a commitment to "all of our stakeholders," including customers, employees, suppliers, and the communities in which companies operate.[8]

Delaware law is unlikely to evolve anytime soon to include an express duty to stakeholders other than stockholders (outside the realm of public benefit corporations). However, board oversight of "mission critical" risk is one area that seems ripe for broadening to accommodate the wider vision of corporate purpose. As reflected in shareholder voting patterns, developments in investor stewardship codes, and a pronounced increase in "voluntary" corporate sustainability reporting, ESG risks such as climate change/environmental, privacy/cybersecurity, consumer/employee safety, and human-capital management are increasingly deemed to be "mission critical" given the immediate impact and/or the impact over the longer term—for all stakeholders—of failing to address these risks.

Moreover, we anticipate that a wide range of stakeholders will continue to vocalize their views and expectations of boards, a trend that is gaining strength. For example, the push to prioritize human-capital management—the concerns of employee stakeholders—is quickly building momentum. This is evidenced by the increased number of shareholder proposals related to labor and human-capital management filed this year compared to the previous year (from 40 to 55), highlighting issues such as gender pay gap, sexual harassment, and inequitable employment practices.[9] Boards should expect that investors will probe deeper into these and other ESG topics as directors are increasingly called upon to demonstrate engagement with and responsiveness to stakeholder concerns.

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7. Delaware Division of Corporations, "2018 Annual Report Statistics."
8. Business Roundtable, "Statement on the Purpose of a Corporation," released August 19, 2019, with signatures updated September 6, 2019.
9. Institutional Shareholder Services, "US Environmental and Social Shareholder Proposals 2019 Proxy Season Review" (October 3, 2019).

The growing focus on corporate culture reinforces the importance of boards setting the tone for the entire corporation and fostering a "speak-up" culture at all levels.

Major Board Implications

1. Focus on Corporate Purpose and Culture

In response to the recent plethora of corporate scandals centered on corporate culture—leading to government investigations, CEO shakeups, loss of market value, and loss of confidence by investors, employees, customers, and the community at large—the institutional investor community is encouraging boards to embrace their leadership roles in establishing corporate "purpose" and "culture." The annual letters released by the CEOs of BlackRock and State Street Global Advisors are public calls for CEOs and boards to establish a strategic purpose and define corporate culture in order to preserve and enhance long-term value for the company's numerous stakeholders. Laurence Fink, reminding CEOs that "the world needs your leadership," writes that "purpose unifies management, employees, and communities. It drives ethical behavior and creates an essential check on actions that go against the best interests of stakeholders."[10] State Street similarly calls on directors to take proactive steps to review and monitor corporate culture, evaluate its alignment with strategy, and incentivize management to take corrective action, if necessary.[11]

In response to heightened focus on the effectiveness of the board's role in the oversight of corporate culture, boards are now taking a deeper look at the topic. In PwC's 2019 Annual Corporate Directors Survey, directors responded that common steps for improvement include enhancing employee development/training programs and whistleblower programs. Directors have also reported that their companies have increased board-level reporting and conducted broad-based employee culture assessments.[12] NACD's 2019–2020 Public Company Governance survey found that 57 percent of directors set clear expectations for management about board-level compliance reporting and 78 percent of directors reviewed reporting trends based on the company's hotline.[13]

The growing focus on corporate culture reinforces the importance of boards setting the tone for the entire corporation and fostering a "speak-up" culture at all levels, so that employees feel that the corporation affirmatively values their raising of concerns about business operations or workplace issues. This also includes ensuring effective escalation

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10. BlackRock's chair and CEO Laurence Fink, 2019 letter to CEOs, "Purpose & Profit."
11. Cyrus Taraporevala, president and CEO of State Street Global Advisors, 2019 letter to board members.
12. PwC, *The Collegiality Conundrum: Finding Balance in the Boardroom* (New York, NY: PwC, 2019), p. 23.
13. The *2019–2020 NACD Public Company Governance Survey* presents findings from NACD's annual questionnaire. The report details responses from more than 500 public-company directors.

processes and requiring senior human resources personnel to report to the board, regularly and directly, on significant human-capital risks. Understanding the types of concerns coming through the company's hotline and other internal reporting mechanisms can be a window for boards into corporate culture.

2. Focus on the Board Agenda and Meeting Minutes

Directors should ensure that the board's agenda provides ample time, on a regular basis, to carefully evaluate the company's overall risk-management framework. This *must* include discussions regarding the identification of "mission critical"/"intrinsically critical" risks facing the company, the effectiveness of the current reporting system to elevate information about such risks from management to the board, and risk-mitigation efforts at both levels. Minutes of board meetings should detail the board's risk-oversight efforts. The minutes should capture not only regular board discussions regarding the company's compliance framework, but also

- the specific steps taken by the board to implement and monitor risk-oversight systems,
- management reports apprising the board of key risks, and
- the board's own perception of risks faced by the company and steps that have been taken or will be taken to mitigate such risks.

3. Focus on Board-Level Risk-Management Systems

Directors should not rely solely on management to effectively escalate critical issues for board attention. Rather, directors should work closely with management to implement, and subsequently monitor, a board-level risk-management system that is attuned to "mission critical" risks faced by the company. This means directors should institute, at the *board level*, protocols that require management to keep the board apprised of central compliance and operational risks in a timely manner.

Boards should consider putting in place heightened reporting controls—including additional reports from management, board committees, and/or outside advisors—in the event the board hears of or otherwise perceives "red flags," or even "yellow flags," threatening the company. Thought should also be given to structural changes in the reporting hierarchy to ensure that employees are being "heard." For example, depending on company circumstances, this could mean implementing a system that encourages employees to report critical risks either anonymously to appropriate senior management or directly to the board to ease any concerns of a direct impact to their careers. Boards may also wish to establish "safety groups" consisting of nonmanagement employees who report on critical safety concerns directly to management or the board.

Directors should work closely with management to implement, and subsequently monitor, a board-level risk-management system which is attuned to "mission critical" risks faced by the company.

4. Focus on the Role of Board Committees and Director Expertise

While the full board has overall responsibility for risk oversight, boards should consider establishing a separate committee to oversee "mission critical" risks to the company. This may be especially appropriate when companies specialize in a single product or service line, or if they are subject to a high degree of governmental regulation. Consideration should be given in the nominating process to recruiting directors who have industry experience or have otherwise dealt with the types of risks that are central to the company.

5. Consider Retaining Outside Advisors

Directors should consider the need for retaining independent outside advisors to better identify and understand key risks facing the company, as well as the effectiveness of the company's overall compliance framework and, more specifically, the risk-management framework at the board level. Boards of monoline companies may benefit from industry-specific experts, who have experience working firsthand with other companies addressing similar "mission critical" risks.

6. Tailor Stakeholder Outreach Efforts

A wide range of stakeholders, affected differently by different risks, are increasingly vocal about their views and their expectations for boards. They want to be heard. Tailored engagement efforts can provide directors with a better understanding of what various stakeholders perceive as the corporation's key business risks, and enable directors to communicate their own commitments to a broadening of corporate purpose and oversight of ESG and other "mission critical" risks.

QUESTIONS THE FULL BOARD SHOULD ASK

- Is the design, testing, and monitoring of a board-level risk-management system currently a board priority?
- Has the board taken a fresh look at identifying the company's "mission critical" risks, including both regulatory/compliance risks and risks from the company's operations, as they may affect the company's broader stakeholder base?
- Does the board address "mission critical" risks on a regular basis?
- Does the board need a separate board committee or industry experts on the board to help monitor "mission critical" risks?
- Are written records of the board's risk-oversight efforts—specifically with respect to "mission critical" risks—maintained in sufficient detail?
- Do any yellow or red flags exist today that call for board scrutiny?

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