

CORONAVIRUS INFORMATION & UPDATES

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Director Oversight Duties Amidst COVID-19

As COVID-19 continues to disrupt every aspect of our lives, companies are taking swift actions to determine and mitigate the risks posed by the new “normal.” Directors have a critical role in helping their companies maneuver through these challenging times. Although management is charged with managing the day-to-day operations of the company, directors are responsible for its oversight and should be mindful of their fiduciary duties in that role.

Directors have a duty of care to make well-informed decisions and a duty of loyalty to act and make decisions in the best interest of the company’s stockholders. Directors are afforded substantial protection against liability for their business decisions, but the widespread and quickly developing risks posed by the COVID-19 pandemic underscore the importance of the board’s active engagement.

As explained in the landmark Delaware Court of Chancery case *In re Caremark International Inc. Derivative Litigation*, directors have a duty to implement adequate information and reporting systems to provide them with the timely and relevant information they need to properly carry out their oversight duties. The absence of such measures could indicate a breach of the duty of loyalty, for which directors have no right to exculpation under Section 102(b)(7) of the Delaware General Corporation Law.

This liability risk is not merely theoretical, as illustrated by the Delaware Supreme Court’s decision last year in *Marchand v. Barnhill, Inc.* In that case, an ice cream manufacturer faced an outbreak of listeria that resulted in three deaths, the shutting down of manufacturing operations, and a liquidity crisis. The ensuing shareholder derivative suit alleged that even though reports about listeria’s growing presence in the company’s facilities were presented to management, no information about listeria or other food safety issues was presented to the board. In holding that the claim could proceed beyond the pleading stage, the court emphasized that *Caremark* duties required the directors to ensure that board-level reporting systems were in place on the specific issue of food safety. Also last year, in *In re Clovis Oncology, Inc.*, the Delaware Court of Chancery found a viable *Caremark* claim where although the board had implemented a reporting and information system, it nonetheless failed to monitor that system once established. In doing so, the board thereby ignored red flags about management’s inadequate response to “mission critical” industry risks. Together, these decisions make clear that it is not sufficient to only have an information and reporting system in place, but the board must maintain an open and continuing dialogue with management to be informed of developments material to the company.

Today, with daily news saturated with coverage of the devastating impacts of COVID-19, it will be harder for directors – especially those in heavily regulated industries facing “mission critical” risks from the pandemic – to claim ignorance of business and compliance risks. As such, directors must not only ensure that board information and reporting protocols are in place, but also actively monitor developments to ensure that management is identifying and addressing the impact of this unprecedented health crisis as it continues to rapidly evolve.

Although plaintiffs must satisfy a high burden to succeed on a *Caremark* claim, directors should remain vigilant in light of the seismic disruptions caused by COVID-19.

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Some Key COVID-19 Issues to Consider.

Below are some key issues management and directors should consider discussing. The board should exercise its oversight responsibilities by asking the right questions, and management should proactively provide the board with relevant information so it is equipped to make well-informed decisions in the midst of the COVID-19 outbreak.

- Financial Impact and Liquidity.
 - *Financial Impact.* Review the short- and long-term financial impacts of COVID-19 on the company, including the impact of the volatility of financial markets. Is the balance sheet strong enough to endure these impacts? Should the company consider “liability management” actions or opportunities?
 - *Liquidity.* What are the company’s anticipated liquidity needs during the pandemic? Will the company be able to meet all of its debt obligations? What lines of credit can the company draw from and should the company consider drawing down from them now? Should the company consider seeking additional financing or amending the terms of existing debt arrangements? Management should consider reporting to the board the company’s ability to comply with the financial covenants under its debt agreements, whether there are any negative covenants that would prevent the company from taking certain measures in response to COVID-19-related risks, and whether any amendments of those covenants should be sought.
 - *Dividends and Share Repurchases.* Consider whether the company should pull back or defer declared dividends or suspend or reduce dividends. On the other hand, if the financial position of the company is strong, consider whether the company should take advantage of the depressed stock prices and expand its share repurchase program.
 - *Governmental Assistance.* Are there any governmental assistance programs the company can participate in or tax credits the company can claim? Management and the board should be aware that businesses accepting relief under the CARES Act may be prohibited from paying dividends or making other capital distributions and from repurchasing any of its or its parent entity’s securities listed on a national stock exchange.
- Health and Safety. What are the health and safety risks to the employees, customers, other stakeholders and the general public? How can the company prevent and mitigate those risks? How many employees have tested positive with COVID-19? What health and safety measures are and should be in place? Are these measures based on internal or external expert health care advice?
- Operations, Employees and Compensation.
 - *Operations and Employees.* How many facilities and employees have been affected by government-ordered shutdowns? How many employees need to have remote working arrangements in place? Is the company considering layoffs or furloughs, and if so, what are the short- and long-term consequences? Are contingency plans in place in the event a key employee or a large number of employees test positive for COVID-19? The board should ensure that management is planning for reopening business and facilitating employees returning to work once lockdown restrictions ease. We recommend that management seek legal advice regarding the “back-to-work” safety measures that the company plans to

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implement, such as screening employees permitted to return to work and requiring them to undergo temperature checks.

- *Compensation.* Consider reviewing compensation plans and whether delays or readjustments are required. In light of the volatility of the financial markets and stock prices, should alternative forms of compensation be provided? Management and the board should be aware that decisions regarding executive compensation may have negative reputational impacts. The board should consider using historical stock price valuations to determine the appropriate stock grants to management so the public does not perceive the compensation as a windfall to management despite furloughs and layoffs of other employees. Some senior members of management and directors are even taking cash compensation cuts. On the other hand, the board should remember to take a balanced approach and remain mindful that the company provide sufficient incentive to management and key employees.
- Shareholder Relations.
 - *Shareholder Activism.* Is the company presently more vulnerable to shareholder activism? Is the company equipped with advisors and contingency plans to address this risk? Do the board and management have a cohesive narrative to address activist criticism of management's response to the COVID-19 outbreak and any related decline in the company's stock price? Has the company had a regular and periodic dialogue with its stockholders? Do the company's public disclosures provide such a narrative? See the discussion on "*Public Disclosures*" below.
 - *Hostile Takeovers.* Is the company currently more vulnerable to a hostile takeover? Is the company prepared to defend against an opportunistic and unsolicited overture at this time? Consider whether the company should prepare a poison pill "on the shelf" or actually adopt a poison pill, and what the related trigger percentage should be under the circumstances. Management should consider reassessing antitakeover measures and defense plans if they have not yet done so, including measures in its bylaws that can be changed without stockholder approval, and in any event ideally in advance of receiving an unsolicited offer.
 - *New Investors.* Consider whether the company would be well served at this time by welcoming new investors into the company's stock, such as private equity sponsors who may be willing to take a long-term view of the company's prospects. This may take the form of a PIPE (private investment in public equity) transaction or other raising of "confidence capital" from investors. This may provide a "smart money" valuation benchmark on the company's stock at a time when there may be uncertainty, and may serve to alleviate investor fear of the impacts of the COVID-19 outbreak. This sort of transaction could even be considered as a defense to shareholder activism or a hostile offer.
 - *Stock-Drop Litigation.* Given the extreme volatility of the market caused by the COVID-19 outbreak, it is likely there will be a rise in stock-drop litigation. The board and management should focus on ensuring that past public statements do not expose the company to claims that the company misled the shareholders, and management should also consider reviewing pre-COVID-19 public disclosures for any exposure to potential shareholder claims. See the discussion on "*Public Disclosures*" below.
 - *Other Shareholder Matters.* Should the company hold virtual shareholder meetings? Does state law or the company's governance documents allow virtual shareholder meetings, and does the company have the infrastructure and resources to hold such a virtual meeting?

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- Public Disclosures.
 - *Public Reporting and Disclosure.* Should the company make any disclosures about actual or potential impacts of COVID-19 on the operations and financial health of the company? The SEC has been making statements and providing guidance on what disclosures need to be made regarding COVID-19. In its statement on March 15, 2020, the SEC advised that companies' disclosures should discuss the nature of the board's role in overseeing the management of the material risks related to COVID-19. Management and directors should consider adding a description of board oversight of material risks related to COVID-19 in their proxy statement disclosures. We recommend that companies closely follow SEC statements and guidelines on required disclosures specific to COVID-19.
 - *Investors and Analysts.* Should the company update or withdraw previously issued earnings guidance? What is the company's plan in communicating with investors and analysts about COVID-related risks to the company?
 - *Internal Disclosure Controls.* Consider reviewing and updating internal disclosure controls so that corporate disclosures are accurate, reflecting the material impacts to and developments in the company.
- Supply Chain, Customers, and Other External Obligations.
 - *Supply Chain.* What are the disruptions and potential disruptions in the supply chain? Have any critical suppliers been affected and should the company support these critical suppliers? What alternative suppliers are available?
 - *Customers and Other External Obligations.* Is the company able to perform its contractual obligations to customers and other contractual partners? Is the company communicating with its customers, suppliers and other contractual partners about any decisions that will impact them? What are some of the material contracts, such as facility and office leases, that may be impacted by COVID-19-related risks? Can the company work with its contractual partners to find solutions that are mutually acceptable?
- Insider Trading. On March 4, 2020, the SEC advised that insiders becoming aware of risks related to COVID-19 should refrain from engaging in securities transactions with the public. Consider placing restrictions on trading in company securities by insiders who may have nonpublic material information related to COVID-19, or even temporarily suspending 10b5-1 plans. Even if such restrictions are not required, management and the board should discuss whether they should hold on to company securities to demonstrate belief in the company and its business plan and show solidarity with the company's shareholders.
- IT Infrastructure and Cybersecurity. As more employees work remotely and by necessity business is conducted virtually, the board and management should consider whether the company's IT systems have enough capacity to support the growing virtual environment. Should management hire consultants to consider alternative communication platforms? In addition, are proper cybersecurity protection measures, policies, and contingency plans in place? Do the employees working remotely have proper cybersecurity training and are they aware of the company's internal communication protocols and policies? Do those protocols and policies need to be updated?
- Transactional and Other Business Opportunities. While the current circumstances are distressing and present many risks to the company, the disruptions caused by COVID-19 may also present opportunities to the company. Consider whether there are any strategic acquisitions or other business opportunities the companies can pursue.

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Recommended Measures for an Effective Information and Reporting System.

To enable the directors to efficiently carry out their oversight duties and consider the key issues listed above and any other issues material to the company, we recommend that companies take the measures listed below.

- Communication.
 - *Regular Board Meetings.* A proper communication mechanism is key to establishing an efficient and accurate information and reporting system. Management and the board should keep lines of communications wide open. We recommend that management and the board set up weekly meetings to discuss new COVID-19 developments relevant to the company. Management and the board should also be prepared to hold ad hoc meetings in the event of developments material to the company. Given the logistical restrictions imposed by governmental orders, the company should ensure that management and the board have telecommunication capabilities that enable them to hold regular meetings.
 - *Coordinated Communication.* Management and the board should ensure that proper communication mechanisms and policies are in place. They must ensure that material information is first disclosed and discussed among the management and the board so that the board does not first learn about developments from other sources. All communications outside the boardroom, including internal employee communications and disclosures to the general public, should be made using coordinated efforts.
 - *Online Communication and Cybersecurity.* Virtual and online communications play a crucial role in enabling the board and management to efficiently communicate and carry out their governance and oversight responsibilities. Is the board technologically equipped to discharge its duties remotely? Should the board consider implementing board portal software that allows them to communicate, share information and schedule and hold meetings on a secure platform? On the other hand, increasing the virtual workspace means increasing exposure to cybersecurity risks. The board and management should make sure that they are aware of the company's cybersecurity and communication policies and avoid communicating and holding meetings in unsecured platforms. The board and management should also ensure that specific communication protocols are in place to avoid any unintentional leakage of confidential information.
- Standing Committee and Crisis Management Team. Depending on the number of directors and the board's composition, the board should consider also convening a standing committee to regularly meet with management to specifically discuss issues raised by the COVID-19 outbreak. Management should also consider forming a crisis management team dedicated to coordinating efforts in determining the COVID-19-related risks and appropriate responses and communicating with the board.
- Record-Keeping. In *Marchand*, one of the key facts that the court considered in concluding that the plaintiff successfully alleged that the board failed to carry out its *Caremark* duties was the lack of any recorded discussion related to food safety issues. Plaintiffs rely on information obtained through corporate books and records requests to bring *Caremark* claims. The board should not only hold regular discussions regarding COVID-19-related risks to the company, but should make sure to memorialize such discussions in its minutes.

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- Contingency and Succession Plan. Management and the board should also put in place contingency and succession plans in the event any members of management or the board test positive for COVID-19 and are not able to carry out their duties.

Finally, while we recommend that directors take these measures, directors should be careful not to overreach and supplant management in running the day-to-day operations of the company when addressing the risks and challenges presented by COVID-19. Courts have recognized that a *Caremark* claim remains one of the hardest theories for plaintiffs to plead and prove. As long as proper information and reporting systems enabling the directors to make well-informed decisions are in place and the directors continue to monitor the evolving situation, the business judgment rule will help insulate the substance of their decisions from second-guessing by shareholders and courts.