

BOARD PERSPECTIVES

ISSUE 163

A Call for Transparency Amid a Shifting Legal and Regulatory Landscape

The increasing complexity of the legal and regulatory landscape is challenging the board's fiduciary duties of care and loyalty. Emerging trends ushering in a call for fairness and transparency should be of paramount importance to directors.

Boardroom agendas cover a wide array of topics, touching on strategy, execution, market opportunities and emerging risks as well as issues pertaining to stakeholder capitalism and sustainability strategy. No matter the topic, there are important underpinnings to board oversight and governance.

Duty of care requires directors to make decisions pursuant to the corporation's interests with the diligence and prudence expected of a reasonable person in similar circumstances. *Duty of loyalty* requires directors to place the company's and shareholders' interests before their own. These responsibilities necessitate a proactive commitment to establish appropriate goals and strategies, relevant metrics and measures, and effective performance-monitoring disciplines. They also entail setting appropriate expectations with investors and other stakeholders and reporting the company's progress toward meeting those expectations in a fair and transparent manner. Done well, these actions engender confidence and trust in the marketplace.

As stakeholder expectations and reliance on voluntary and obligatory disclosures increase, there are signs that legislators, regulators and the plaintiffs' bar are gearing up for action. Below, we discuss 10 trends contributing to a shifting legal and regulatory landscape. We also present a set of guiding

questions designed to highlight potential areas for improving the company's processes and readiness as well as the board's governance and oversight. Some of the trends are interrelated. Their relative importance will vary by company depending on the industry, facts and circumstances. While some examples apply specifically to the U.S. and European Union (EU), the trends they reflect may also be evident in other countries.

10 Trends Relevant to Boards

Heightened regulatory scrutiny and enforcement.

The U.S. Securities and Exchange Commission (SEC) established the Climate and ESG Task Force in the Division of Enforcement in 2021, expanded climate-related disclosure rules, and increased its scrutiny and enforcement of

environmental, social and governance (ESG) representations in public filings and sales and marketing materials. The EU's Corporate Sustainability Reporting Directive provides a regulatory framework, with specific reporting deadlines, on corporate sustainability governance. It requires certain companies to publish regular reports on their environmental and social impact activities, with effects on multinationals as well as companies headquartered in the EU.¹ These developments affect public companies' due diligence defenses, create disclosure exposure for private companies operating in Europe, and increase the likelihood of exposure of misleading, inconsistent or inaccurate ESG representations.

Mandatory cybersecurity disclosures. The SEC's proposed cybersecurity disclosure rules express and imply various registrant obligations by drawing attention to consumer data protection. They also impact 8-K filings, incorporating a process for materiality analysis that potentially serves as a basis for civil litigation. In proposing Item 106(b) of Regulation S-K, the SEC argued that disclosure of cybersecurity policies and procedures would benefit investors by "providing greater transparency" regarding the registrant's strategies and actions to manage relevant cyber threats.

10 LEGAL AND REGULATORY TRENDS

1. Heightened regulatory scrutiny and enforcement
2. Mandatory cybersecurity disclosures
3. Increasing number of shareholder derivative suits
4. Evolution of the Caremark standard
5. Escalating books and records exposure
6. Expanded disclosures to investors
7. Increased focus on disclosure controls
8. Proliferating data privacy regulations
9. Rising importance of D&O risk insurance
10. Supply chain-related representations

¹ Companies headquartered or operating within the EU should seek legal advice to ascertain whether they are subject to these requirements.

Increasing number of shareholder derivative suits. Earlier this year, shareholders of a major oil company filed suit alleging that the company’s directors were personally liable for its failure to set meaningful emissions targets.² In addition, numerous workplace safety, diversity and inclusion, and employee discrimination shareholder suits have been filed for fiduciary breaches of duty (loyalty and oversight), some of which allege false and misleading disclosures regarding board diversity. This activism is expected to continue.

Evolution of the Caremark standard. The conditions for director culpability and oversight liability under Delaware law in the U.S. are established under the Caremark standard.³ In 2019 and 2020, four decisions regarding Caremark claims survived motions to dismiss.⁴ In one case, the Supreme Court of Delaware concluded that the facts set forth in the complaint created “a reasonable inference that the directors consciously failed to ... [ensure] a reasonable information and reporting system existed.”⁵ Thus, the burden of proof can be met by plaintiffs if the board doesn’t take necessary steps. The recent Delaware Court of Chancery decision⁶ to deny a motion to dismiss a shareholder derivative suit against a company officer defendant also sends a message that the duty of loyalty under the Caremark standard applies to corporate officers as well.

Escalating books and records exposure. In a 2021 case, books and records demands under 8 Del. C. § 220 were used by the plaintiff as the basis for conducting pre-complaint discovery to obtain the necessary facts to support a Caremark claim.⁷ This case could set a precedent for future discovery efforts by plaintiffs attempting to hold directors personally liable on a wide range of director oversight obligations. The noted case highlights the importance of good recordkeeping and reporting practices to proactively identify and address enterprise red flags.

Expanded disclosures to investors. Institutional investors, asset managers and proxy advisory firms have emerged as de facto standard-setters through their use of ESG to screen investments and evaluate corporate performance. Lack of a uniform ESG disclosure framework, the cumulative impact of stakeholder attention on ESG financing and greenwashing issues, and an appetite for more “green” investment vehicles have driven companies to enhance ESG-related reporting to the market. These developments have increased the importance of fair and transparent sustainability reporting.

² “Board Directors and Executive Officers Beware: Personal ESG Liability Is Here,” by Conor Chell, Laura Roberts and Maya Douglas, MLT Aikins, February 16, 2023: www.mltaikins.com/esg/board-directors-and-executive-officers-beware-personal-esg-liability-is-here/.

³ The Caremark standard holds that litigants must prove that directors either knew or should have known that violations of law were occurring and, *in either event*, that directors took no steps in good faith to prevent or remedy the situation *and* such failure resulted in the alleged losses.

⁴ “The Risk of Overlooking Oversight: Recent Caremark Decisions From the Court of Chancery Indicate Closer Judicial Scrutiny and Potential Increased Traction for Oversight Claims,” by Edward B. Micheletti, Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, December 15, 2021: www.skadden.com/insights/publications/2021/12/insights-the-delaware-edition/the-risk-of-overlooking-oversight.

⁵ “The Caremark Standard: Tough, But Not Impregnable,” *Board Perspectives*, Issue 118, Protiviti, August 2019: www.protiviti.com/sites/default/files/2023-01/Board-Perspectives-Risk-Oversight-Caremark-Standard-Issue118-Protiviti.pdf.

⁶ “The Ramifications of The Delaware Court of Chancery’s McDonald’s Decision — Beyond Holding That Caremark Oversight Obligations Apply to Corporate Officers,” Jason M. Halper et al., *The National Law Review*, February 9, 2023: www.natlawreview.com/article/ramifications-delaware-court-chancery-s-mcdonald-s-decision-beyond-holding-caremark.

⁷ “In re The Boeing Company Derivative Litigation,” In the Court of Chancery of the State of Delaware, September 7, 2021: <https://courts.delaware.gov/Opinions/Download.aspx?id=324120>.

Increased focus on disclosure controls. Under Section 302 of the Sarbanes-Oxley Act, an issuer's chief executive officer and chief financial officer are required to certify quarterly the effectiveness of the company's disclosure controls in ensuring that material information is disclosed in public reports. The SEC's recent \$35 million settlement with a video game publisher⁸ piggybacked a charge of failure to maintain proper disclosure controls onto the commission's enforcement action over alleged mishandling of employee harassment complaints and workplace misconduct. Currently, there are developments in the market in favor of segmenting the controls underlying ESG reporting, labeling them as "internal control over sustainability reporting" (ICSR), which would further spotlight their importance to investors, regulators and the plaintiffs' bar.

While the trends highlighted herein present potential minefields for corporate directors and the companies they serve, there are actions boards can take to shore up their governance and oversight.

Proliferating data privacy regulations. Legislation modeled after the EU's groundbreaking General Data Protection Regulation continues to evolve in various U.S. states and in countries around the world to assure consumers that their personal information remains private. The large fines assessed in recent years⁹ suggest that regulators are increasing their focus on organizations that fail to comply, making the protection of individual rights a corporate data governance imperative. Transparency relating to the use of personal data in market-facing representations is a consistent theme in sanctions imposed by the U.S. Federal Trade Commission (FTC) and European regulators, in the text of regulations governing the use of personal data, and in enforcement actions. Earlier this year, the SEC announced amendments to its Privacy Act rules that would "account for modern technology, as well as provide the public with greater transparency into the Commission's use of this data."

Rising importance of directors and officers (D&O) risk insurance. Risk insurance, coupled with improved risk predictors, assumes greater importance as expanded disclosure requirements and the related D&O exposure proliferate through enforcement, civil litigation and shareholder suits. The assessment of the probability of future harmful legal events supports the evaluation of the level of risk insurance needed and drives the extent and cost of coverage.

⁸ "What the SEC's *Activision Blizzard* Settlement Means for ESG Enforcement Trends, Company Disclosures, and Whistleblower Protections," Jane Norberg et al., Arnold & Porter, February 23, 2023: www.arnoldporter.com/en/perspectives/advisories/2023/02/what-the-secs-activision-blizzard-settlemt-means.

⁹ "The 12 Biggest Data Breach Fines, Penalties, and Settlements So Far," by Michael Hill, CSO, September 12, 2022: www.csoonline.com/article/3410278/the-biggest-data-breach-fines-penalties-and-settlements-so-far.html.

Supply chain-related representations. Scope 3 emission disclosures will be a game changer for supply chain relationships as issuers will be required to disclose emissions by those activities for which they are indirectly responsible, both upstream and downstream in the value chain. Issuers should expect increased negotiation over such matters as the extent of carbon cost pass-through, necessary updating of vendor contracts, and resolution of breaches and disputes. They can also expect increased regulatory and vendor/customer ecosystem attention to reducing — with emphasis on discontinuing — reliance on high-emitting suppliers.

Suggested Diagnostic Questions for Boards

While the trends highlighted above present potential minefields for corporate directors and the companies they serve, there are actions boards can take to shore up their governance and oversight. The following are suggested questions that are intended to facilitate boardroom discussions with management, including the general counsel. While not intended to be exhaustive, they may be useful when crafting a road map for effective boardroom vigilance in this shifting legal and regulatory landscape:

Fairness and transparency in ESG strategy and reporting

- Is the company's ESG strategy, including net-zero emissions transition plans, credible and realistic? How reliable is the company's methodology for measuring, tracking and reporting its greenhouse gas emissions? Is management satisfied that emissions data is suitable to support public disclosures?
- What is the company's confidence level that it can deliver on the sustainability goals and targets it communicates to the public?

Litigation matters

- Based on recent enforcement, regulatory and litigation trends affecting the board's ESG oversight, what are the specific requirements for directors to avoid personal liability? Is the expertise of the board and senior executives aligned with the ESG risks facing the organization?
- Is the company prepared to respond to large-scale litigation and the related enterprisewide document requests? To that end, has an assessment been performed addressing topics such as the following:
 - Legal data collection readiness testing to evaluate preparedness for pre-complaint discovery?
 - The process for identifying and managing ESG-related risks?
 - Lessons learned from recent ESG shareholder litigation relative to board oversight approach and actions?

- A formal litigation response team with the competency and resources to respond appropriately in accordance with applicable legal requirements?
- Policies for informing the board when litigation commences or is reasonably expected?
- Protocols to address pre-litigation discovery under books and records requests, including legal holds¹⁰ and policies for limiting the scope of discoverable books and records?
- Should the company engage a third-party review of potential shareholder exposure? Should assessments of the ESG strategy, performance monitoring and disclosure process be subject to legal privilege to preempt third parties from obtaining access to the confidential results?
- To what extent will D&O insurers scrutinize corporate governance policies, stock price volatility, reporting practices, activist shareholder risk and other factors when assessing litigation exposure during the underwriting process? Would proactive reviews or audits of ESG compliance facilitate preferred or more attractive, cost-effective coverage? Would assessing risk reduce downstream risk (litigation or regulatory sanctions) and, correspondingly, result in lower insurance premiums?

Disclosure matters

- What are management’s protocols for reviewing corporate disclosures and representations for fairness of presentation prior to publication? How should the company balance its desire to showcase its sustainability commitments with increased exposure to litigation risk? Are there steps that would limit exposure to greenwashing accusations in light of recent litigation claims and SEC and other non-U.S. regulatory investigations?
- Has the company reviewed the disclosures in the annual report (10-K in the U.S.), proxy materials, website content, marketing collateral and sustainability reports for consistency?
- Is there a periodic assessment of the design and operating effectiveness of ICSR by qualified, objective evaluators, including the internal audit function? If there are areas to improve the design or execution of ICSR, are steps taken to address them on a timely basis?

The rise of stakeholder capitalism makes it important for boards to prioritize building and maintaining trust in their decision-making and communications with management.

¹⁰ A legal hold is the process by which an organization preserves potentially relevant information when litigation is either pending or reasonably anticipated.

Cybersecurity, data privacy and supply chain matters

- Does management have a documented process for identifying and managing cybersecurity risks? Does the company access the Cybersecurity and Infrastructure Security Agency threat landscape database and advisories to facilitate improvements to cybersecurity infrastructure?
- Does the company have in place privacy and data protection risk management processes to facilitate alignment with proliferating global and state requirements as well as accurate, transparent and timely disclosures?
- How will the company address the disclosures required in its annual reports, including its policies and procedures to identify and manage cyber risks and the board and management's related cybersecurity expertise?
- What are the board-level considerations in assuming, transferring or mitigating legal risk with the company's contractual partners, including under applicable country- and state-specific data-sharing obligations? When was the last time corporate third-party contracts were reviewed in light of recent ESG developments?

The current dynamic legal and regulatory landscape points to a vital message: *Trust is an essential element of an organization's success and reputation.* Trust is earned through setting and articulating credible goals and strategies, establishing accountability for results, and emphasizing fairness and transparency in market-facing communications. These are the ultimate mechanisms for navigating the changing environment successfully. The rise of stakeholder capitalism makes it important for boards to prioritize building and maintaining trust in their decision-making and communications with management.

The current dynamic legal and regulatory landscape points to a vital message: *Trust is an essential element of an organization's success and reputation.*

How Protiviti Can Help

Today's companies and their legal executives face a diverse and dynamic set of challenges. We partner with the C-suite, general counsel, in-house counsel, law firm partners and other key organizational leaders to successfully manage legal workflows, contract management, legal compliance, records retention, legal privacy, corporate transactions and investigation-related business challenges.

We provide a customized blend of alternative legal services, including global consulting, managed solutions and talent management, to help companies quickly and efficiently achieve results, optimize their legal function, and dramatically reduce costs while improving risk mitigation and business outcomes. We help corporations and law firms increase efficiencies, manage risk and reduce overall spend related to their litigation portfolio, including investigations and disputes. We also assist finance, risk and compliance, and internal audit professionals in discharging their responsibilities in the ESG space.

Authors



Joel Wuesthoff
Managing Director
Protiviti Legal Consulting
joel.wuesthoff@protiviti.com



Rich Cohen
Managing Director
Protiviti Legal Consulting
rich.cohen@protiviti.com

Protiviti (www.protiviti.com) is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Protiviti and our independent and locally owned Member Firms provide clients with consulting and managed solutions in finance, technology, operations, data, analytics, digital, legal, HR, governance, risk and internal audit through our network of more than 85 offices in over 25 countries.

Named to the 2023 *Fortune* 100 Best Companies to Work For® list, Protiviti has served more than 80 percent of *Fortune* 100 and nearly 80 percent of *Fortune* 500 companies. The firm also works with smaller, growing companies, including those looking to go public, as well as with government agencies. Protiviti is a wholly owned subsidiary of Robert Half (NYSE: RHI). Founded in 1948, Robert Half is a member of the S&P 500 index.

Protiviti partners with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on <https://blog.nacdonline.org/authors/42/>. Twice per year, the six most recent issues of *Board Perspectives* are consolidated into a printed booklet that is co-branded with NACD. Protiviti also posts these articles at protiviti.com.