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GLOBAL PUBLIC COMPANY ACADEMY

Securities Litigation Update

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Delaware's Continuously Evolving *Caremark* Jurisprudence

- Directors of Delaware corporations owe a duty of oversight—to ensure that the company has internal systems in place by which compliance with the law is monitored and reported to the board, and, when problems arise, the board must address them.
- Liability for failing to do so has long been referred to as a "*Caremark* claim."
- Traditionally, *Caremark* liability arises when:
  - The company has no reporting system in place at all, or
  - There is a reporting system, and the board thereby learned of "red flags" but consciously disregarded them.

➢ Until a few years ago, *Caremark* claims rarely survived a motion to dismiss, largely because of exculpation in companies' charters eliminating directorial liability for the duty of care.

➢ That meant that boards would only be held liable for a failure of oversight when their oversight failure effectively amounted to an intentional decision to do nothing when circumstances dictated action.

Delaware's Continuously Evolving *Caremark* Jurisprudence

- Times have changed
- In recent years there has been a series of decisions denying motions to dismiss *Caremark* claims
- *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019) (denying motion to dismiss involving listeria outbreak at an ice cream manufacturer)
- *In re Clovis Oncology, Inc., Derivative Litigation,* 2019 WL 4850188 (Del. Ch. Oct. 1, 2019) (denying motion to dismiss involving violations of clinical trial protocols at drug manufacturer)
- Takeaways as of a few months ago (stay tuned)…
  - Potential *Caremark* litigation risk is heightened when "mission critical risk" is concerned
  - Potential *Caremark* litigation risk is heightened when safety is at issue
  - No case has found *Caremark* liability for "business risk" oversight failures
  - No case has found *Caremark* liability for officers, just the board

Delaware's *Caremark* Jurisprudence: "The times they are a changing"

- *In re McDonald's I – Caremark* claim upheld on motion to dismiss against former officer for allegations that the officer allowed a corporate culture that condoned sexual harassment.
- Plaintiff stated a claim because former officer had day-to-day responsibility for overseeing HR function, knew of EEOC complaints, and was disciplined for acts of sexual harassment.
- *In re McDonald's II* – Separate decision, Court dismisses complaint
  - While a claim was pled against the officers, it failed against the board

Takeaways …

- ➢ Opening the door to *Caremark* liability outside "mission critical" areas.
- ➢ Opening the door to *Caremark* liability outside safety concerns.
- ➢ First case to hold that *Caremark* applies to officers (more later).

Managing *Caremark* Liability Risk and the Role of Section 220 Books and Records Demands

- Obviously, create, maintain, and monitor reporting systems to the board.
- The rise of *Caremark* litigation risk corelates with the rise of plaintiffs using the "tools at hand" – Section 220, pre-suit discovery – books and records demands.
- Books and records are not just board minutes; even emails and texts are potentially fair game if the "official record" is incomplete.
- Plaintiffs' lawyers use books and records to draft one-sided complaints—far more dangerous when informal communications are involved.

  - ➢ Takeaway #1 – maintain the official record with thorough board-level materials.

Managing *Caremark* Liability Risk and the Role of Section 220 Books and Records Demands

- The evolving law of the "Incorporation By Reference" doctrine

- Ordinarily a motion to dismiss is limited to the allegations of the complaint, accepted as true

  - Through incorporation by reference, 220 books and records can be referred to by defense counsel on a motion to dismiss for limited purposes of rebutting "cherry-picking"
  - Cannot be used to rewrite the complaint
  - Evolving jurisprudence holds that "if it isn't in the 220 record, it did not happen"
  - Plaintiffs then get the benefit adverse inferences of wrongdoing
  - Example: Board sees "red flag" that reporting system had deficiencies and seeks to address them by hiring reputable counsel to conduct a review. If the minutes do not reflect that the board then also acted upon the results of that review by reforming policies, the plaintiff-friendly inference is that the "board consciously chose to do nothing"

  ➢ Takeaway # 2 – Thoroughly document the board's actions and follow up in the minutes

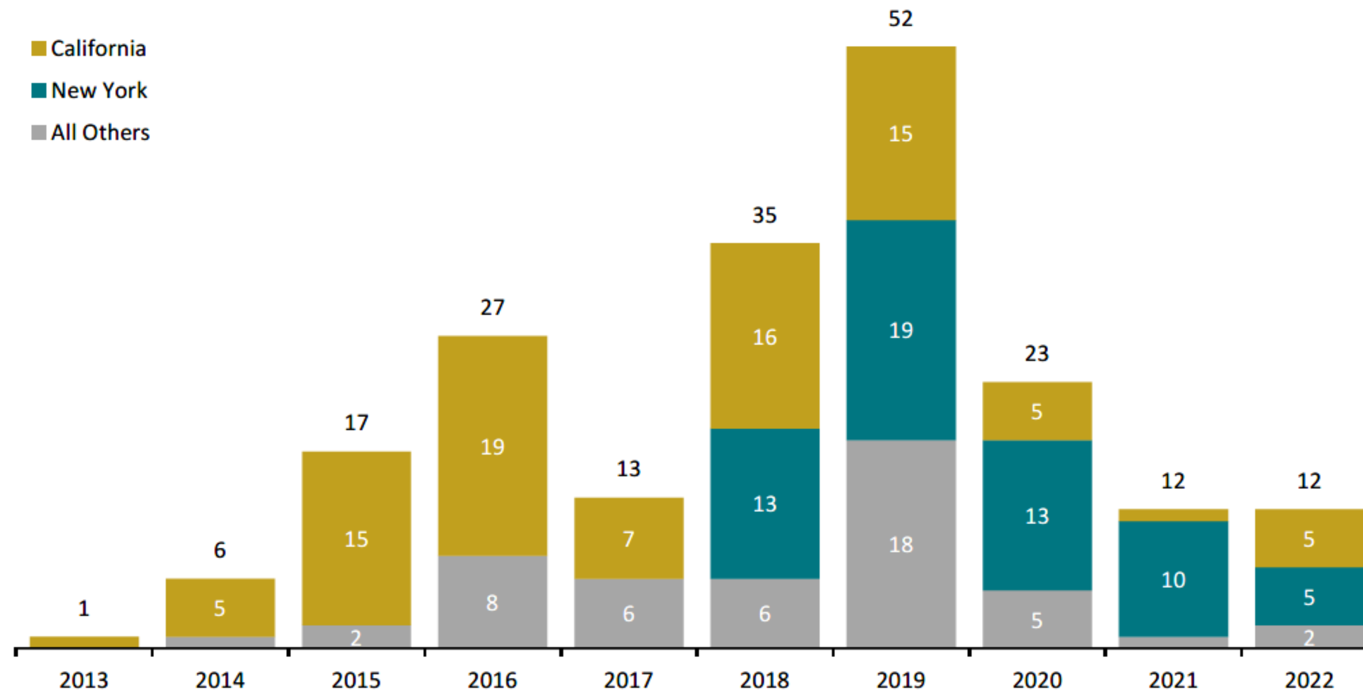
Officer Liability and Exculpation – A New Frontier?

- There has been a spike in derivative litigation against officers, taking advantage of relaxed standards for liability (no exculpation) in comparison to directors.
- Section 102(b)(7) of the Delaware General Corporation Law authorizes a corporation to include in its certificate of incorporation a provision exculpating directors from damages for breaches of the duty of care (but not the duty of loyalty).
- In August 2022, Delaware legislature extended Section 102(b)(7) exculpation to officers.
  - Unlike for directors, however, officer exculpation *does not apply* to derivative actions.
- Likely because of the limited value in officer exculpation due to the derivative action exclusion, as well as uncertainty about ISS and Glass Lewis views, there has not been a flood of certificate amendments adopting 102(b)(7) officer exculpation clause.

Officer Liability – A New Frontier

- *In re McDonalds*—officers owe oversight duties – will likely increase litigation naming officers along with the board.
- Typical defense to derivative claims against officers
  - If also directors, the conduct must have been in an officer capacity
  - Otherwise, demand futility
- Academics have debated standards for officer conduct for years but, until recently, there has been little litigation defining the parameters.
  - Does the business judgment rule even apply to officers, or is the standard mere negligence?
- *In re McDonalds* – "Officers generally only will be responsible for addressing or reporting red flags within their areas of responsibility, although one can imagine possible exceptions. If a red flag is sufficiently prominent, for example, then any officer might have a duty to report upward about it. An officer who receives credible information indicating that the corporation is violating the law cannot turn a blind eye and dismiss the issue as 'not in my area.'"

State Court 1933 Act Filings Remain Down Post-*Sciabacucchi*



1933 Act Cases Filed in State Courts, 2022 Year In Review, Cornerstone Research (2023)

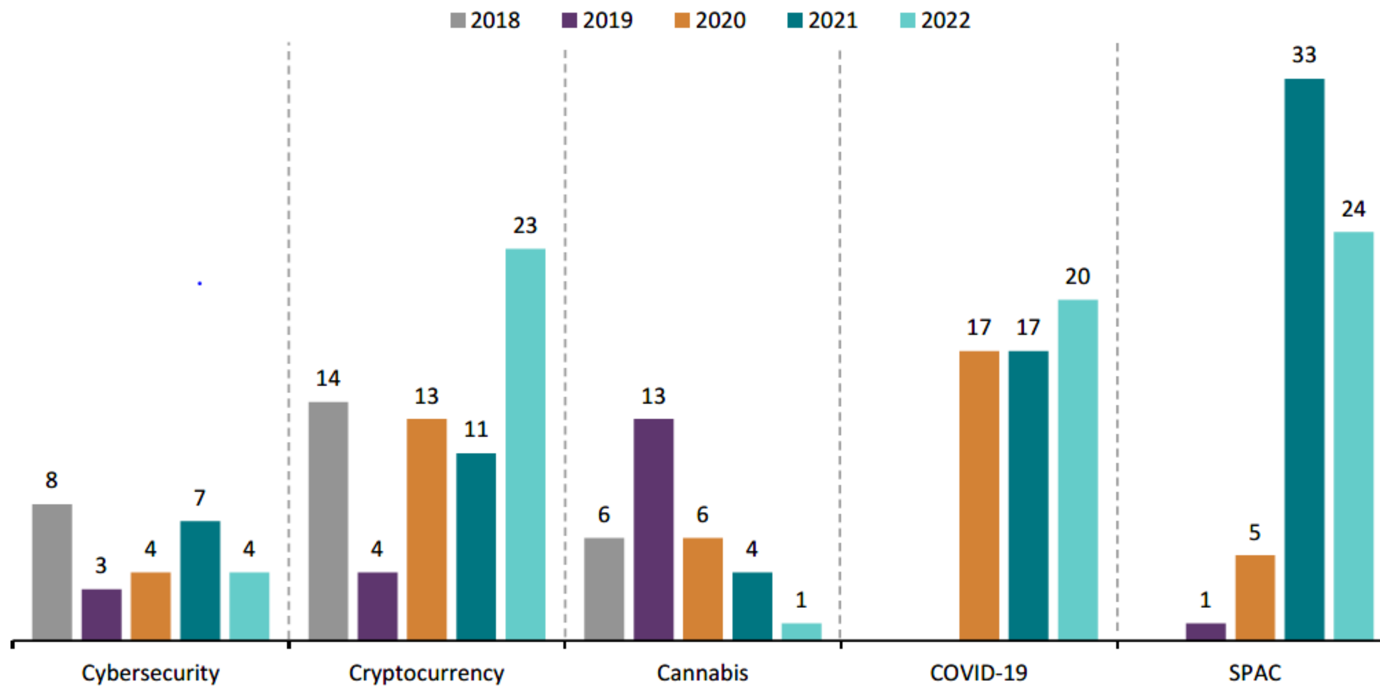
Recommend Adding an Exclusive Federal Forum Bylaw

- Companies should add exclusive federal forum provision to bylaws
- Example Bylaw Provision from *Sciabacucchi*:

> "Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of [the Company] shall be deemed to have notice of and consented to [this provision]"

- Recommend adding "To the extent not prohibited by law"

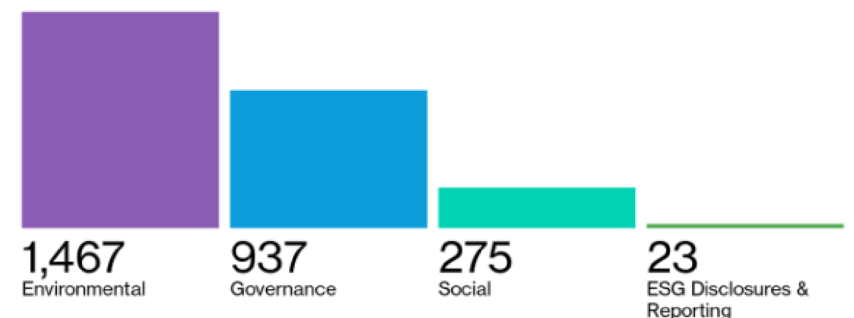
Hot Topics in Securities Filings



Summary of Trend Cases, 2022 Year In Review, CORNERSTONE RESEARCH (2023)

Could ESG Securities Litigation Be the New Trend?

- ESG has been a hot news topic in multiple capacities, rules from SEC and DOJ
- In 2022, SEC proposed new rule requiring publicly traded companies to increase disclosures on climate-related risks and include climate-related financial metrics in audited financial statements.
  – Much debate over the new rule, expected to be finalized in April
  – Private litigation implications to be seen, but SEC is bringing enforcement actions based on "greenwashing"
- ESG-related securities cases are being filed against companies that have been proactive on ESG issues but then have challenges in executing those ESG initiatives.
  – Complaints filed on ESG issues in 2022 were overwhelmingly environmental
- Shareholders have also begun to send demand letters and bring cases against directors and officers on the theory that the company's ESG policies are illegal and/or wasteful.
- In this way, companies that are active on ESG issues may in fact face increasing litigation risk.



Cases to Keep an Eye On

- Series of recent bank failures led to securities suits
  - Silicon Valley Bank
    - First case filed in N.D. Cal. March 13, 2023
    - Class period: June 16, 2021 - March 10, 2023
    - Section 10(b) and 20(a) claims based on failure to disclose risks of high interest rates
  - Signature Bank
    - First case filed in E.D.N.Y. March 14, 2023
    - Short class period: March 2-12, 2023
    - Section 10(b) and 20(a) claims for failure to disclose susceptibility of takeover by New York DFS and likelihood of regulatory action
  - Credit Suisse
    - First case filed in D.N.J. March 16, 2023
    - Class period: March 10, 2022-March 15, 2023
    - Section 10(b) and 20(a) claims based on omission of significant outflows in Q4 2022 and material weaknesses in internal controls
- Supreme Court considering *Slack Technologies LLC v. Pirani*
  - Involves Sections 11 and 12(a)(2) standing and traceability – i.e., who can sue?
  - Argument set for April 17, 2023
  - Unclear whether decision will have broader implications for future

Advance Notice Bylaws

- Requiring shareholders to give timely written notice to a company prior to the annual shareholder meeting of plans to submit proposals to nominate a board candidate or vote on other matters.
- Commonly used and challenged since at least the mid-1990s.
- Trending topic, partly because of SEC's new universal proxy rules and the *Masimo* litigation.
- Companies looking to ensure orderly nomination and election process and full disclosure by activists and dissidents so that stockholders are fully informed of conflicts of interest and other relevant facts.

Politan Capital v. Masimo Corp.

- Politan Capital, a hedge fund run by activist investor Quentin Koffey, disclosed an 8.8% stake in Masimo Corporation, a $7 billion medical device maker founded and led by billionaire Joe Kiani.
- Masimo board adopted bylaws imposing two disclosure obligations prior to any stockholder nominations of new directors: (1) limited partners of the nominator and (2) plans to nominate directors at other companies.
- Other Masimo defenses:
  - Traditional poison pill
  - Staggered director terms
  - Advance notice period of 120 days
  - Parachute payment (up to $1 billion) to Kiani if (1) shareholders elect two new directors or (2) the board designates a lead independent director

Politan Capital v. Masimo Corp.

- Politan sued Masimo in the Delaware Chancery Court.
- As the case progressed, Vice Chancellor Cook denied Masimo's motion to dismiss Politan's claim concerning the parachute payment after conveying concern about its terms.
- At the same time, investment community voiced condemnation of the new bylaws given limited partner and director nomination confidentiality considerations.
- Masimo ultimately unilaterally rescinded its advance notice bylaw without explanation, but the trial continues.
- Lessons?

Universal Proxy

- On November 17, 2021, the SEC voted to adopt final rules requiring the use in contested director elections of "universal proxy cards" that name all director nominees up for election – those of the company and dissident.
- The universal proxy card debuted when the SEC rule became effective January 31, 2022. The amendments apply to any shareholder meeting involving a director election after August 31, 2022.
- Viewed as a boon for activists, shareholders can now vote by proxy for preferred combination of candidates nominated by the company's board of directors and the dissident shareholder in a proxy contest.
- Previously, it was difficult for shareholders to mix and match management and dissident nominees unless they attended a company's annual meeting in person.

Universal Proxy – Proxy Contests

- State of play during proxy season:
  - Argo Group International
  - Apartment Investment and Management Co.
  - AIM Immunotech
  - Diffusion Pharmaceuticals
  - The Walt Disney Company
- Impact of new SEC guidance?

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

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Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
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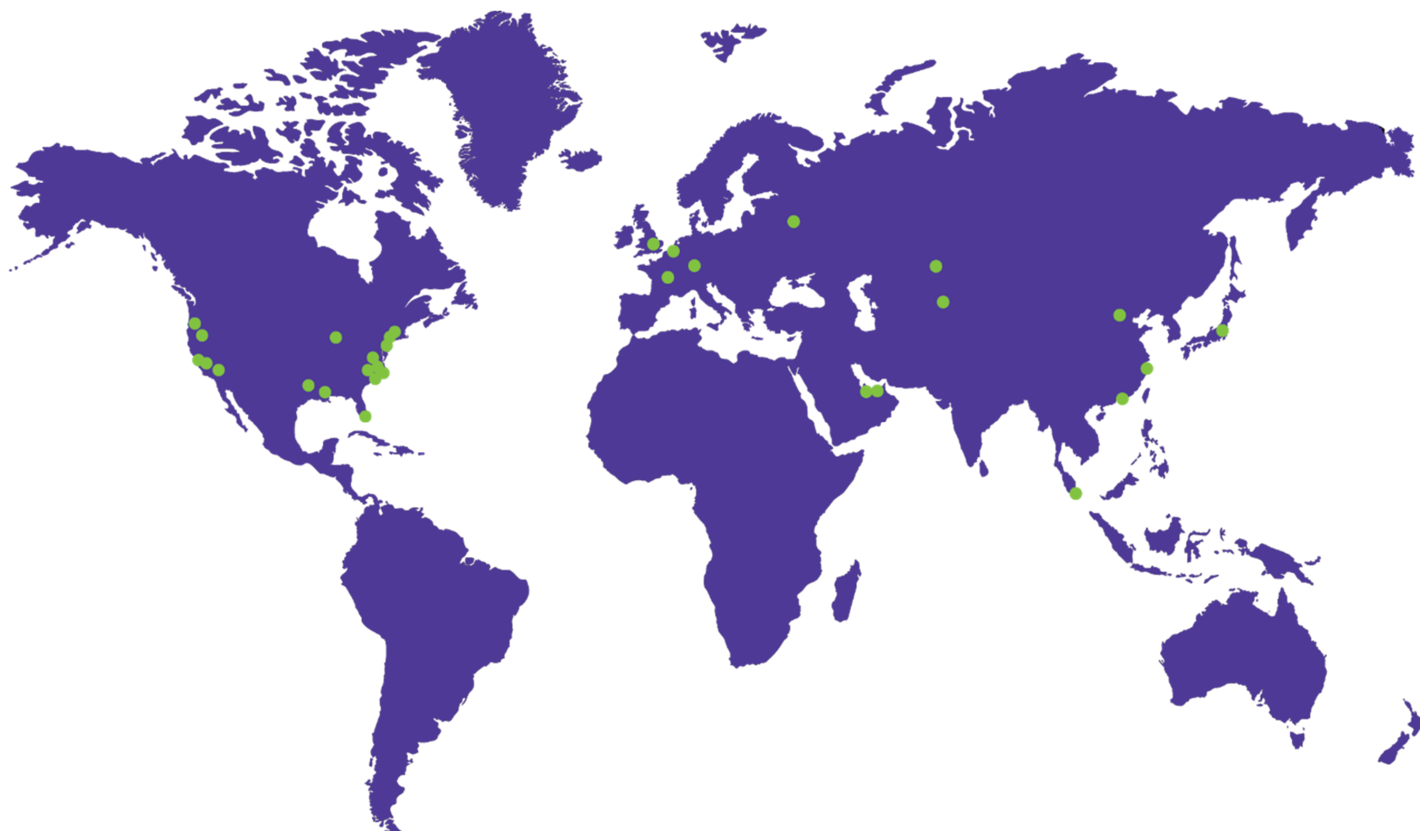

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