General Counsel and Other Governance Professionals of Publicly Listed, Family Controlled Companies
December 7, 2023
9:00-10:15 a.m.

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EESG That is Effective and Efficient . . . And Just Makes Good Business Sense

A Framework to Help Corporate Directors and Managers Align EESG with Legal Requirements, Reporting and Monitoring

An Unavoidable Reality For Public Companies in 2023: You Can't Just Do Caremark, You can't Just Do EESG, You Have To Do Both

- Public Companies are under tremendous pressure to allocate resources to address diverse compliance, risk management, and EESG ("Employee, Environment, Social & Governance") issues.
- Organizing a management structure that reaches the board level is challenging, and it is difficult to have time for management and the board to address all key issues, and thus it is important to be efficient.
- Recognizing these realities, the need to think innovatively how to employ limited resources more efficiently and thus effectively is one of the most compelling issues for public companies, and role that puts General Counsels in the forefront.

Our Solution: Return to First Principles

Managers and directors can address this key challenge by implementing an EESG program that is tailored to corporate needs and capitalizes on existing governance structures without utilizing increasingly scarce corporate resources by aligning EESG with the company's existing compliance and operational risk systems.

First Principles: Conduct Lawful Business by Lawful Means

- Corporate law requires corporations to conduct only lawful business by lawful means.
- This first principle of corporate law is enshrined in the corresponding fiduciary duty of directors to implement a reporting system to monitor the corporation's compliance with the law and then use that system to oversee the corporation's operations.

> "Corporate boards may [not] satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."
>
> — *Chancellor William T. Allen, In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996)

Caremark's Flexibility

- Although directors and officers must "implement an oversight system and then monitor it," they are given a great deal of latitude in how they implement that system.
- Each corporation is different, and the appropriate monitoring system should be tailored to the corporation's legal obligations, operations, and risks.

> "[D]irectors have great discretion to design context- and industry-specific approaches tailored to their companies' businesses and resources. But *Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting."
>
> — *Marchand v. Barnhill*, 212 A.3d 805, 821 (Del. 2019)

Recent *Caremark* Decisions: Internal Monitoring and Reporting are Crucial

Caremark (1995):

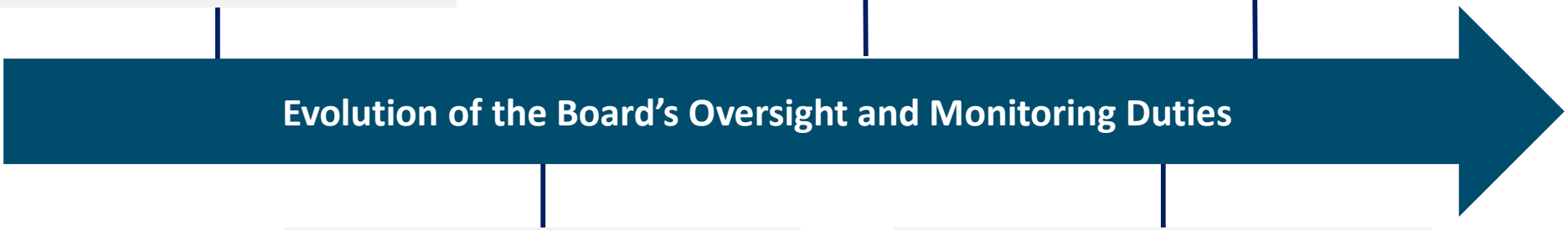
Directors may face exposure only if company "utterly failed" to implement a system for risk identification or if they intentionally "ignored a red flag"

Clovis (2019):

A board "comprised of experts" that "operates in a highly regulated industry" should have understood misreporting by management and intervened to fix the problem

Boeing (2021):

Board faces liability for lack of any formal mechanism or written record of oversight regarding "mission critical" product safety risk



Marchand (2019):

"[D]irectors must make a good faith effort to implement an oversight system and then monitor it." Consistent with *Caremark* itself, the mere existence of management-level compliance programs is not enough for the directors to avoid *Caremark* exposure

Teamsters Local 443 (2020):

Board materials showing mere director "review" of red flags, when "tangible action" is called for, may not suffice to defeat a *Caremark* pleading

Boeing: What Exposed the Board

- **Locus of Monitoring**:
  - No board committee was charged with direct responsibility to monitor airplane safety—no mention in any charter.
  - Risk oversight generally was concentrated within audit committee, which had no specific mandate to oversee airplane safety.
- **Reporting System**:
  - There was no internal reporting system by which whistleblowers and employees could make concerns known to the board (as opposed to management).
- **Records**:
  - Minutes and agendas reflected a lack of urgency and minimal time allocated to airplane safety, even after a fatal crash.
  - When mission-critical risk—here, airplane safety—was discussed, it was couched in terms of profitability and production efficiency.
  - There was no apparent record of stand-alone focus on customer safety.
  - No committee charter mentioned the central business and consumer risk of airplane safety.
  - 220 is a sword and shield.

Boeing: Lessons & Cautions

- **Director Engagement**:
  - Lack of active engagement and pushback from directors can expose the board.
- **Identify and recognize risks that are "mission critical":**
  - These are often not directly financial in character, and even when a business's products are financial – such as insurance or banking – that does not mean they should be assumed to be properly covered by Audit Committee's focus on financial reporting.
  - These non-financial but central risks merit proper, stand-alone attention.
  - Ask this question: what could go wrong that would cause the most harm to the company and its stakeholders?
    - The answer will usually be an area where high legal, business, stakeholder, and reputational risk come together.
    - Airplane safety was Boeing's biggest risk in all these areas.

Boeing: Lessons & Cautions *(cont'd)*

- **Consider locus of oversight**:
  - Audit Committee is typically not the best place for consideration of core industry compliance.
    - Financial expertise may not be necessary or sufficient.
    - Directors with relevant expertise – pharma or food safety or aircraft industry experts – may not qualify for the Audit Committee.
  - Audit Committee's traditional duties themselves are challenging and can crowd out other issues.
    - Audit already covers financial reporting and (typically) cybersecurity.
    - The line at Audit is too long and Audit looks at risk through a primarily financial lens, when other perspectives are often as or more relevant.
    - Spread The Load: Consider board structures that more effectively address all material risks.
  - Audit remains important, and can and should approve the overall EESG/compliance approach, but spreading the load makes sure all risks are likely to be covered well, and, most critically, that the most important industry-specific risks are handled with appropriate care and expertise.

Boeing: Lessons & Cautions *(cont'd)*

- Compensation Committee often is a full-blown workforce committee and addresses all HR issues, including not just executive compensation, but workforce and contracted workforce pay issues, DEI, and issues of workplace tolerance and climate (e.g., policies precluding sexual harassment and promoting an inclusive workplace).
- Consider deploying a committee that focuses on the central business risks of the company and other existential risks outside the core concerns of Audit and Compensation.
- Too many board structures do not give key managers with risk/compliance responsibilities – such as HR or core product safety/reliability — adequate time regularly with a sector of the board.

- **Use This Opportunity To Capitalize on Diversity In All Respects**:
  - The public sector, educational institutions, non-profits, and military in particular have done better in creating racially and gender-diverse management ranks.
  - Many of these managers have relevant expertise in key issues like cybersecurity, supply chain risk, HR management, and regulatory risk that can be valuable to a well organized board.
  - Thus, by organizing the board well, the needs for more diverse talent can be met while meeting the demand for more racial and gender diversity.

Boeing: Lessons & Cautions *(cont'd)*

- **Discuss, push back, and put it on the record**:
  - Board should consider and discuss core industry compliance and safety issues separately from financial impact.
  - Directors should press management on its evaluation of these issues.
  - Make sure there is a good record of that discussion and consideration:
    - Absence from 220 production of records of evidence of oversight supports pleading stage inference of lack of good faith effort: Where "the board minutes of the relevant period revealed no evidence that these [red flag safety concerns] were disclosed to the board, it is reasonable to infer the absence of a reporting system"
    - Good records can aid a dismissal motion.

A 2023 *Caremark* Reminder: Even When You Win The Case Your Reputation Will Take a Hit

- Courts are uncomfortable even when dismissing cases where companies have been found to have engaged in conduct that is publicly embarrassing.
- As the recent decisions involving McDonald's by the Delaware Court of Chancery show, even when the court concludes that a derivative case should be dismissed for demand excusal, the court may feel obliged to call out conduct of officers it views as deeply troubling and to send a message that the court's dismissal is not a signal that the conduct is acceptable or considered appropriate fiduciary behavior.
- In an environment where press scrutiny, regulatory intensity, activism, and litigation pressures are high, it is more important than ever to have an efficient and effective system to address all material compliance and EESG risks.

Caremark and EESG

- *Caremark* sets the floor: requiring a business to operate a lawful business by lawful means
- A Company looking to implement an EESG program is focused on going above and beyond the floor, and by doing so, the Company can both satisfy legitimate demands for strong EESG programs and promote compliance with the law

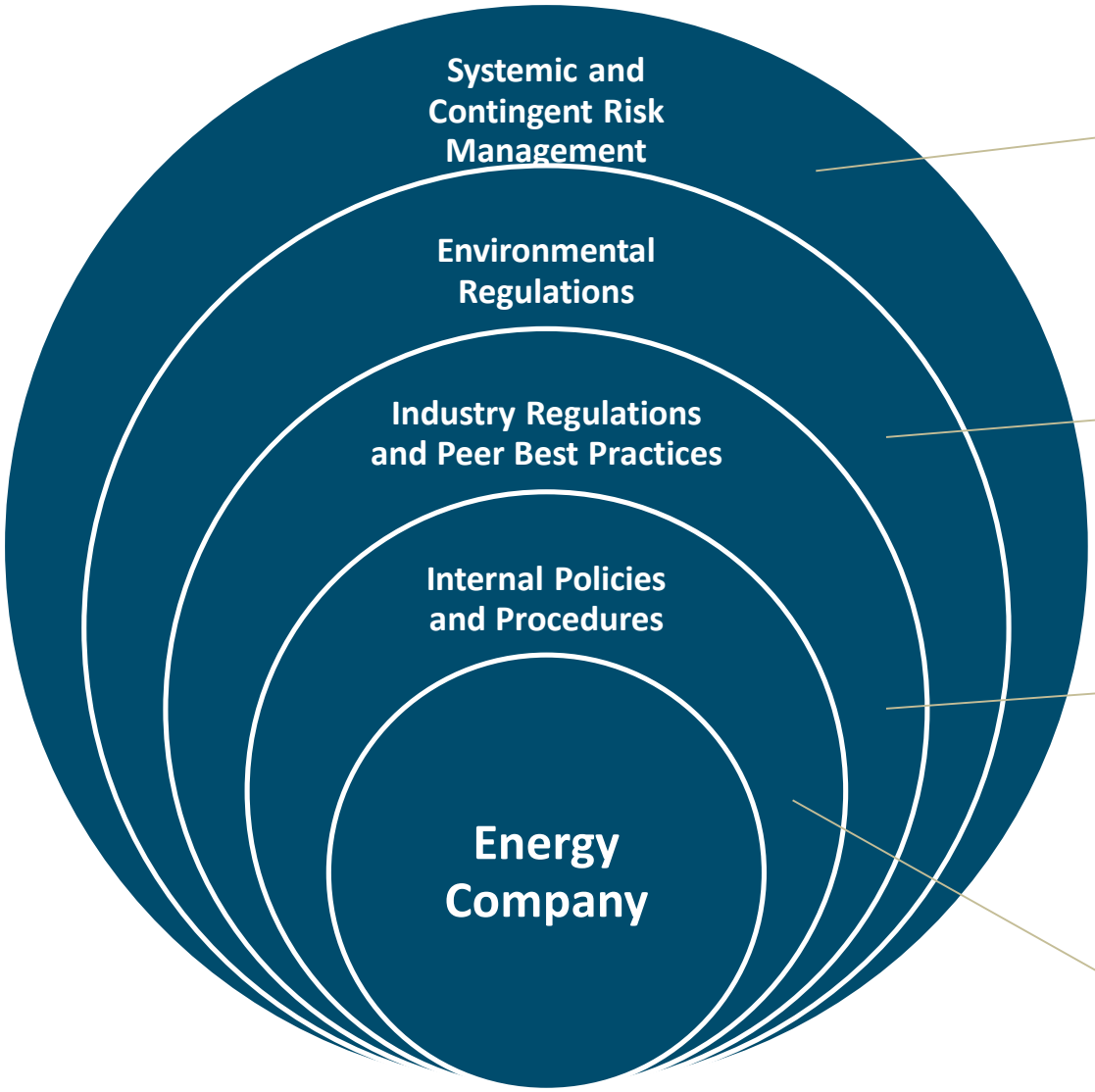
What *Caremark* Requires:

- Understand the company's business:
  - How does the Company make money?
  - What risks are inherent in the Company's operations?
  - What legal requirements must the Company comply with?
  - What key regulatory frameworks does the Company operate within?
- Create a reporting infrastructure for monitoring legal/operational risk:
  - Does the Board receive reports about the amount of operational risk the Company is taking?
  - Has the Board considered the appropriate amount of operational risk?
  - Is the Company complying with its key legal requirements?
- Monitor the Company's legal compliance:
  - Does the Board regularly review reports about legal/operational risk?
  - Does the Board receive regular updates from management about the Company's regulatory compliance or operational risks?

Existing *Caremark* Processes Inform EESG:

- Business operations and risks should be the focus of EESG—the company's biggest risks are also the areas where it can have the largest effect.
- EESG Reporting can be created or enhanced based on the existing reports the Board or management receives on operational risk/compliance.
- Monitoring the Company's EESG performance and setting appropriate EESG targets can only be holistically done if the Board has the information to understand what the current reality is and what is possible.

Example: Overlap Between EESG and Compliance Function



- Does the company's risk management process incorporate EESG considerations?
- Has the Board reviewed risk management through the EESG lens?

- Is the company in compliance with federal, state and municipal regulations?
- Has the company evaluated future regulatory risks?

- Is the company in compliance with industry best practices?
- How does the company compare to its peers? Is it a leader in EESG-related initiatives?

- Do the company's internal compliance policies incorporate EESG considerations?
- Do the company's internal reporting policies facilitate the reporting of EESG risks?

Bottom Line:
EESG is an Extension of the Board's Oversight or "*Caremark*" Duty

Management-Led, Board-Approved EESG Assessment and Realignment Process so that Directors' Role is Enhanced

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To move towards an EESG reporting and monitoring system that builds on the company's current monitoring and reporting obligations involves engaged management leading a process of (1) assessment; (2) engagement; and finally (3) realignment.

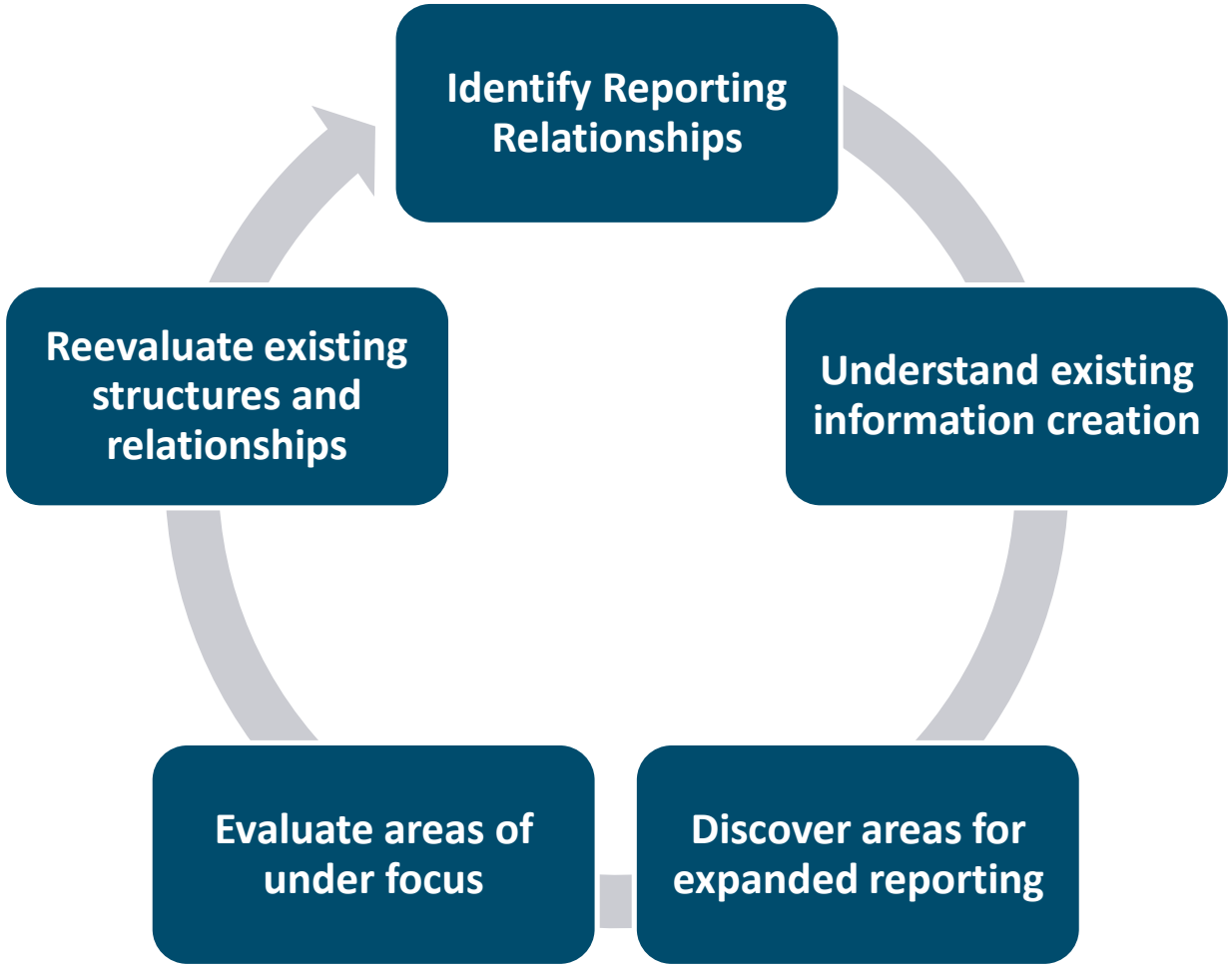
Assessment

Through an assessment of the Company's existing governance structure, operational risk and legal requirements, and existing reporting capabilities, company management create a holistic picture of the current governance structure around reporting on and monitoring of risks and legal compliance.

Existing Governance Structure	Operational Risk and Legal Requirements	Existing Reporting Capabilities
• Existing board committee structure • Allocation of responsibilities among board committees • Director skills and committee membership	• Industry-specific risks • Company-specific operational risks • Regulatory environment	• Existing board-level reports (e.g., sustainability reports) • Publicly available regulatory reports

Engagement

Conducting a targeted dialogue with members of management and staff can help create a better understanding of (1) existing internal reporting relationships; (2) existing information creation, dissemination and flow; (3) capacity for expanded reporting or oversight; and (4) under focused areas of risk can be discovered.



Realignment

Based on the additional insights gleaned from engagement with management and key staff, management can engage the board in assessing the necessary realignment of (1) governance responsibilities; (2) management responsibilities and oversight; (3) reporting priorities and expectations; and (4) goals around compliance and EESG.