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Memorandum

Considerations for Corporate Directors As Their Companies Confront COVID-19

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As the coronavirus disease 2019 ("COVID-19") continues to disrupt the global economy, corporations across sectors and industries are confronting a host of questions about how to adapt to the extraordinary challenges posed by the pandemic. While management is handling the day-to-day response to the burgeoning crisis, boards of directors face a unique set of considerations and must think critically about how best to fulfill their fiduciary duties in the wake of disruption, volatility and uncertainty. This memorandum provides a brief refresher on the foundational principles governing a director's fiduciary duties and then discusses some of the issues directors should consider as they navigate this unprecedented environment in order to meet their obligations and mitigate the risk of future liability.

Background

Directors owe fiduciary duties of care and loyalty. These duties collectively require directors to act in good faith, on an informed basis, and in the best interests of the corporation and its stockholders. Courts assess directors' conduct in discharging these duties through the lens of the business judgment rule, a rebuttable presumption that they acted in good faith, on an informed basis and with the honest belief that their actions were undertaken in the corporation's best interest. This presumption shields internal business judgments from second-guessing by courts in many circumstances.

Directors can be sued for breaching their duties to adequately oversee the affairs of the corporation—subjecting them to a so-called *Caremark* claim. *Caremark* liability requires evidence that the board systematically failed to ensure a reasonable system of controls or, having implemented such a system, consciously ignored red flags signaling noncompliance. While *Caremark* claims are regarded as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," two recent Delaware decisions—*Marchand v. Barnhill* and *In re Clovis Oncology, Inc. Derivative Litigation*—serve as important reminders that courts are willing to sustain *Caremark* cases over a motion to dismiss where the board of directors allegedly failed to institute, or sufficiently monitor, appropriate controls to address known, and material, compliance risks. *See Marchand v. Barnhill* (recognizing a *Caremark* claim against the board of Blue Bell ice cream where the board allegedly failed to implement adequate food safety monitoring controls); *In re Clovis Oncology, Inc. Deriv. Litig.* (recognizing a *Caremark* claim where the board allegedly failed to monitor existing oversight mechanisms despite numerous "red flags" signaling non-compliance). Although *Caremark* continues to be a significant hurdle for stockholders alleging oversight failures, Delaware's recent oversight jurisprudence underscores the need for

directors to be mindful about how their roles may be scrutinized in both the context and the aftermath of COVID-19.

Directors must also be cognizant that when they are evaluating extraordinary corporate issues, such as strategic or defensive measures, their fiduciary decisions may be judged in hindsight under heightened standards of review which minimize the impact of the business judgment protection and give the courts greater latitude to assess director decision-making.

Key Considerations for Boards

While there is never a single blueprint to address any particular corporation's unique needs, a prudent board should, at a minimum, take steps to understand the risks and opportunities the COVID-19 pandemic presents to the corporation, ask relevant questions, and take timely and informed action to ensure that management is addressing those risks and evaluating relevant opportunities to the greatest extent possible. Some specific steps and considerations are as follows:

- **Assess Business Risks in the Current Environment, Including Health and Safety Issues**. Boards should proactively discuss with senior management the business risks and workplace health and safety issues posed by COVID-19. As part of these discussions, boards should keep abreast of federal and state legal developments, review the corporation's risk-mitigation strategies and protocols, and, working in conjunction with management, ensure that those protocols comport with the evolving regulatory environment. To ensure that they take an active role in monitoring both the adequacy and the implementation of the corporation's risk-mitigation framework, directors should meet early and often, solicit appropriate expert advice, consider the formation of additional committees to oversee the corporation's COVID-19 response and document their processes. Further, each respective board committee should assess the impact of the pandemic and related legislation on corporate governance issues within the ambit of its specific mandate.
- **Review and Consider Public Disclosure and Earnings Guidance**. Boards should work with management to take a close look at the corporation's disclosures to ensure that they accurately convey any material business risks posed by COVID-19 or the rapid changes in the business environment resulting from COVID-19 and related government response measures. While each corporation's disclosures are different, consideration should be given, at a minimum, as to how to articulate the risks posed by the current health and financial situation in the corporation's MD&A and Risk Factor disclosures, financial statements and other relevant disclosures to ensure that they are appropriately disclosing known risks, trends and uncertainties. For corporations facing financial uncertainty, consideration should also be given as to whether and when to amend or withdraw any existing financial guidance.
- **Evaluate and Stress-Test Liquidity Profile**. As corporations experience operational disruptions, boards should take steps to understand and address the corporation's near-term liquidity needs and current debt structures, taking into account available revolvers, lines of credit and key covenant terms.

Directors should be cognizant of the fact that a weak economic environment may enlarge the group of stakeholders with standing to bring a derivative claim for alleged breaches of fiduciary duty. In Delaware, for example, creditors have standing to bring such a claim when a corporation's balance sheet reflects insolvency.

- Directors of corporations that declared stock dividends before the crisis should think critically about whether the corporation has a sufficient surplus to proceed with payment. While the declaration of a dividend often creates an irrevocable debtor-creditor relationship, corporations may nonetheless have latitude in determining whether and how to proceed and should seek appropriate guidance. Individual directors of a Delaware corporation may be held personally liable for an unlawful dividend payment.
- Given the rapidly evolving environment, boards should engage in discussions with management about the corporation's long-term labor force needs and work closely with senior executives to critically assess those needs. Relatedly, boards should be involved in overseeing issues surrounding employee compensation (including performance-based compensation), taking into account evolving state and federal regulations, the corporation's liquidity needs and the interests of shareholders. Boards should also remain informed of any legal changes pertaining to relevant federal support initiatives.

- **Debt and Equity Repurchase Considerations**. While economic volatility has created opportunities for issuers to repurchase their debt and equity securities at favorable prices, directors should be aware of their, and the corporation's, obligations under applicable state and federal securities laws.
  - In light of securities laws governing trades made while in possession of material non-public information, issuers should analyze the impact of COVID-19 and the current business environment on their financial operations, prior disclosures and previously-announced guidance before undertaking any repurchases. They should also assess the impact of any such trades on the liquidity of the subject securities. Material non-public information could potentially include knowledge of recapitalization and debt restructuring initiatives that would have an impact on the trading levels of securities.
  - In addition, directors should be cognizant of the fact that a Delaware corporation may only repurchase its own shares if it has a sufficient surplus and, further, that individual directors may be jointly and severally liable for any "willful or negligent" violation of the surplus requirement. Issuers also need to be mindful that repurchases are structured to avoid applicable tender rules.
  - Relatedly, in connection with securities law compliance, boards should work closely with senior management and outside advisers to determine whether existing trading policies are sufficiently broad to make clear that they cover material non-public information concerning COVID-19 and possible changes in a corporation's financial prospects. They should take steps to reinforce among officers and employees that trading while in possession of such material information is prohibited.
  - Finally, as of the time this memorandum was issued, restrictions on securities repurchases were under consideration in Congress as part of negotiations over COVID-19 fiscal stimulus legislation.

Boards should confirm the applicability to their corporation of any such restrictions before authorizing any repurchase activity.

- **Conduct a Vulnerability Assessment and Consider Potential Mitigation Steps**. Given the precipitous declines in share prices that sometimes make corporations vulnerable to stockholder activism, boards should consider discussing with expert advisers potential steps to diminish these vulnerabilities. These steps may include implementing vigilant stock watch programs and considering the potential adoption of a shareholder rights plan (or "poison pill"). Any rights plan should be tailored to the current extenuating circumstances. These measures will necessitate careful and informed discussion of, among other things, the percentage trigger threshold, duration, scope of covered derivatives and the exemption for passive investors. Boards must also work closely with management to determine how to appropriately communicate such initiatives to the corporation's stockholders.
- **Review D&O Insurance**. As a result of the financial and economic upheaval caused by the crisis, boards should review their existing D&O insurance policies to understand the scope of coverage in the event of claims arising out of board action taken, decisions made or events that transpire during the crisis. Boards should consider whether enhancements to the existing D&O insurance program (such as the purchase of additional "Side A" coverage) are warranted in light of increased scrutiny of board actions in times of crisis. Boards should also identify D&O insurance provisions implicated by financial distress or potential restructuring to determine appropriate replacement policies and "tail" coverage in the event of a restructuring transaction that has the effect of terminating go-forward coverage for the restructured entity.
- **Don't Forget About Possible Opportunities**. Finally, although the current economic turmoil poses undeniable risks, it also presents potential growth opportunities. While overseeing these risks, boards also should ensure that they are positioning the corporation to pursue transactions that could enhance stockholder value.

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