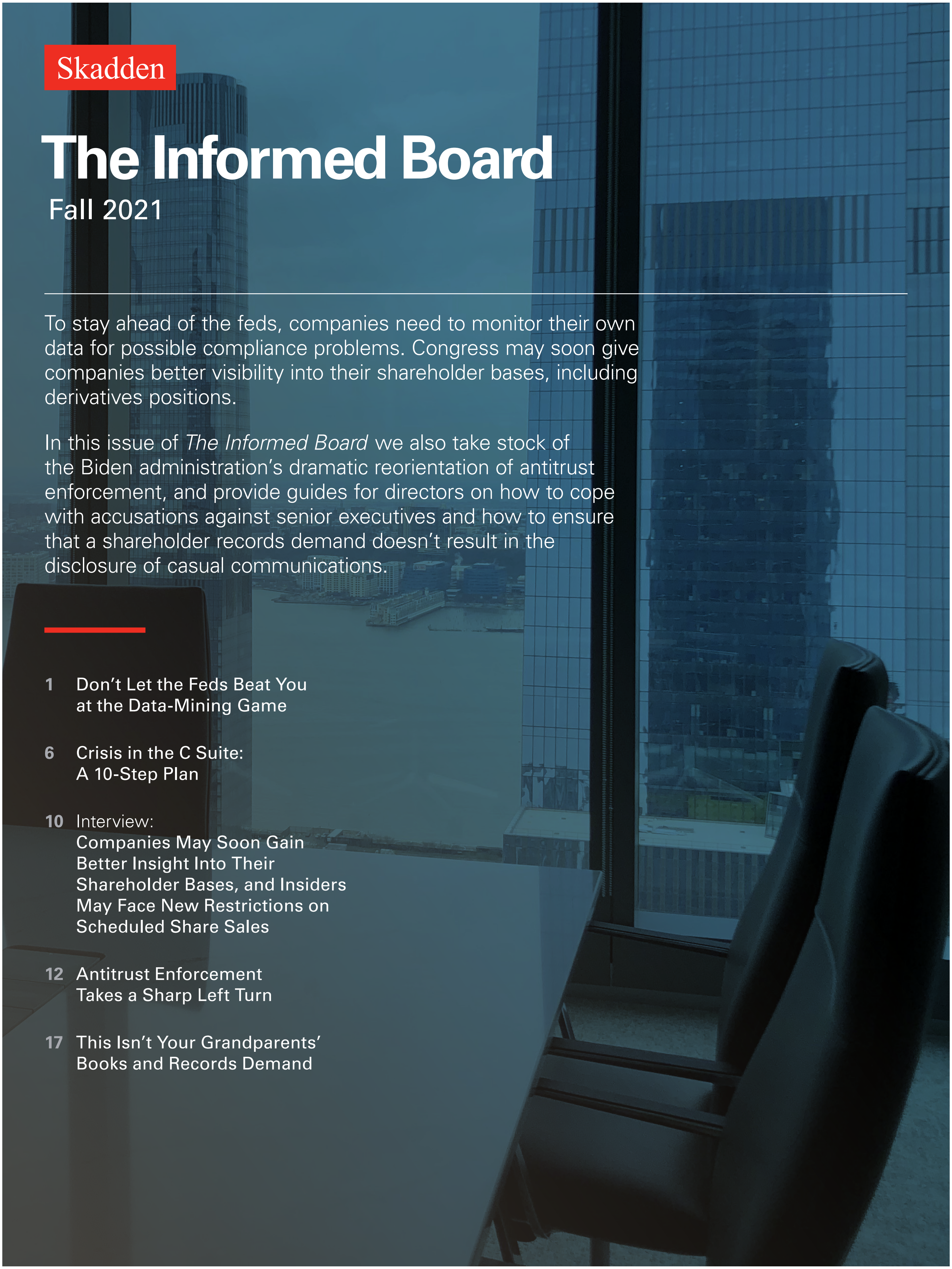

Skadden

The Informed Board

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To stay ahead of the feds, companies need to monitor their own data for possible compliance problems. Congress may soon give companies better visibility into their shareholder bases, including derivatives positions.

In this issue of *The Informed Board* we also take stock of the Biden administration's dramatic reorientation of antitrust enforcement, and provide guides for directors on how to cope with accusations against senior executives and how to ensure that a shareholder records demand doesn't result in the disclosure of casual communications.

Don’t Let the Feds Beat You at the Data-Mining Game

Corporate compliance systems need to adapt to a world where enforcement agencies employ increasingly sophisticated data analytics.

As artificial intelligence and other data tools have proliferated, regulators and prosecutors expect companies to utilize sophisticated data analytics as part of their compliance programs. They also expect directors to take an active role, understanding and overseeing these data-driven compliance programs.

Recent lawsuits, enforcement actions and surveys suggest, however, that many companies have not kept up with the rising expectations and may not be utilizing available data to flag potential compliance problems as well as they could — perhaps not even as well as the government is already doing.

A careful reading of enforcement cases, policies and public statements shows what the government now expects. They provide directors with valuable insights about how to shape more complete, effective and defensible compliance programs.

What the Government Is Looking For

Some aspects of business pose well-known compliance risks: business combinations, foreign operations, foreign clients, privacy protection, interactions with competitors and financial reporting. Traditional compliance programs and due diligence efforts often focus on those, quite sensibly.

Federal officials, however, are placing increasing emphasis on data-driven approaches: (a) They expect companies to monitor and analyze data that could identify potential risk factors or compliance failures. (b) When assessing culpability, they look closely at internal compliance processes and reporting lines. (c) They hold boards responsible for overseeing both.

Although some highly regulated sectors such as financial institutions, life sciences and technology have begun to implement more data-driven approaches to compliance, the importance of data may not be fully appreciated in other sectors.

1 Across the Federal Government, Data Is Being Mined for Enforcement

Prosecutors and regulators have become increasingly adept at crunching large volumes of data to spot potential violations and build cases.

The Securities and Exchange Commission (SEC) has been a leader in using risk-based data analytics. One system provides officials with a dashboard of approximately 200 metrics to help identify abnormalities in corporate financial reports. In August 2021, the commission announced a $6 million settlement resolving allegations that a company inflated earnings per share by failing to properly account for material loss contingencies. It was the third SEC action involving earnings management practices that grew out of the data analytics initiative. Other SEC data systems leverage Big Data to identify suspicious trades and relationships to spot potential insider trading.

The Commodities Futures Trading Commission (CFTC) employed data analytics in an investigation into alleged price manipulation (“spoofing”) in the precious metals and U.S. Treasury futures markets, leading to a $920 million fine in 2020.

The Consumer Finance Protection Bureau (CFPB) utilizes natural language processing tools to analyze consumer complaints and categorize them, helping to identify patterns, and the Department of Justice (DOJ) has tapped data to identify potential False Claims Act cases.

The DOJ also established a Procurement Collusion Strike Force in 2019 that uses data analytics to identify suspicious bid patterns. It also trains auditors, analysts, attorneys and others in the use of data analysis to combat bid rigging and similar collusive actions. As a result, the role of data analytics in antitrust and other enforcement is likely to increase.

2 Companies Are Now Expected To Use Data Analytics for Compliance

With new, more powerful digital tools available, what constitutes a reasonably effective compliance program is rapidly changing. In one recent enforcement case, for instance, the CFPB cited a bank’s lack of systemic, automated controls to detect employee misconduct involving consumer accounts.

Other applications of data-driven compliance programs might include:

a. monitoring for Foreign Corrupt Practices Act violations by analyzing raw data about a company’s foreign transactions, donations, cross-border customers or vendors;

Questions the Feds Will Ask About Your Compliance Systems

The DOJ's Criminal Justice Division published a detailed list of questions it asks about a corporate compliance program when weighing whether to prosecute a company, some of which emphasize the role of data and access to it. It is a good starting place for directors trying to oversee risk management and compliance initiatives.

Key excerpts:

Oversight

What compliance expertise has been available on the board of directors? Have the board of directors and/or external auditors held executive or private sessions with the compliance and control functions? What types of information have the board of directors and senior management examined in their exercise of oversight in the area in which the misconduct occurred? …

Data Resources and Access

Do compliance and control personnel have sufficient direct or indirect access to relevant sources of data to allow for timely and effective monitoring and/or testing of policies, controls, and transactions? Do any impediments exist that limit access to relevant sources of data and, if so, what is the company doing to address the impediments?

Control Testing

Has the company reviewed and audited its compliance program in the area relating to the misconduct? More generally, what testing of controls, collection and analysis of compliance data, and interviews of employees and third parties does the company undertake? How are the results reported and action items tracked?

b. periodically evaluating the risk profiles of third-party relationships;

c. at financial institutions, screening customer transaction data as part of anti-money laundering or "know your customer" programs.

As user-friendly ways to deliver data analyses to compliance personnel proliferate, expectations may change about the level of information that boards should be receiving about risk trends and compliance responses.

Surveys suggest that many companies have catching up to do. According to an EY survey, 78% of companies do not "systemically track contractual obligations," for instance, and 71% do not monitor contracts for "deviations from standard terms." And while half of CEOs interviewed identified "risk management as the area in which they expect to implement the most change over the next three years" — with 61% of those same CEO's saying they "would like their organization to take a more data-driven approach" to risk management generally — 97% of general counsels report difficulty obtaining budgets for legal technology, including tools to monitor risk and compliance issues.

As enforcement agencies rely more heavily on data tools to rout out unlawful conduct, they expect companies to do the same. As Matthew S. Minor, then deputy assistant attorney general, said in 2019:

> Whereas we are able to identify indicators and anomalies from market-wide data, companies have better and more immediate

> access to their own data. For that reason, if misconduct does occur, our prosecutors are going to inquire about what the company has done to analyze or track its own data resources — both at the time of the misconduct, as well as at the time we are considering a potential resolution.

That could be paraphrased as: "You've got the data. Use it."

3 The Analysis Must Be Available to Boards

Enforcement officials have made it clear that data analysis alone will not suffice. The results must make it to decisionmakers, including boards and chief compliance officers (CCOs).

For example, under federal sentencing guidelines, if there is a plea or a conviction, defendants only receive credit for having a generally effective compliance program if directors at minimum are "knowledgeable about the content and operation of the compliance and ethics program," and "exercise reasonable oversight" of its "implementation and effectiveness." One factor in weighing charges involving businesses is "[w]hat types of information … the board of directors and senior management examined in their exercise of oversight . …

Effective oversight also requires sufficient expertise at the board level, the DOJ's prosecution guidelines suggest, whether that comes through expertise among the directors themselves, advisors or compliance training. The guidelines also factor in whether directors or external auditors met privately with compliance and control officers, without management present.

A Deloitte survey suggests that these standards often are not met. At 70% of the companies surveyed, CCOs did not regularly attend board meetings. At almost 40%, they did not even regularly attend audit committee meetings.

Regulators scrutinize those organizational structures. As the SEC's Director for the Division of Examinations stated in November 2020 in the context of investment funds:

> We notice when a firm positions a CCO too low in the organization to make meaningful change and have a substantive impact, such as a mid-level officer or placed

> *"Whereas we are able to identify indicators and anomalies from market-wide data, companies have better and more immediate access to their own data. For that reason, if misconduct does occur, our prosecutors are going to inquire about what the company has done to analyze or track its own data resources … ."*
>
> **– Matthew S. Minor, deputy assistant attorney general, 2019**

> under the CFO function. We notice when CCOs are expected to create policies and procedures, but are not given the resources to hire personnel or engage vendors to provide systems to implement those policies and procedures.

This concern was reflected in a recent criminal investigation of alleged bribery. As part of a non-prosecution agreement, the company created a new position, executive vice president for compliance and audit, that reports directly to the audit committee of the company's parent.

Taking the Hint

No board or CEO wants to discover that the government has a better read on the company's legal compliance than management does. Fortunately, through prosecutions and enforcement actions, sentencing laws and detailed DOJ policies, the government has given clear guidance about the need to employ data analytics, and how that information needs to be shared internally.

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Crisis in the C Suite: A 10-Step Plan

When senior executives are accused of misconduct, directors are thrust into the center of the crisis, with pressure to make quick decisions. Boards need a clear game plan to ensure the allegations are addressed and to minimize potential legal, regulatory, financial and reputational harm.

It's an all-too-common occurence. A senior executive is accused of wrongdoing — sexual misconduct, bullying, financial fraud, a conflict of interest or other conduct posing a compliance or integrity concern. Suddenly, directors find themselves thrust into the center of a crisis, forced to make critical decisions on a short timeline, often in the glare of a public spotlight.

It's a time for clearheaded thinking and a game plan. Here's a 10-point guide for directors for the first few, critical days.

1 **Make a quick, preliminary assessment of the seriousness of the allegations and establish a proper investigation structure:** The first step is to assess the allegations and determine whether the conduct, if true, could constitute a criminal offense, a regulatory violation, a violation of company policies or a breach of the executive's employment agreement, or raise a reputational concern. Boards often assign these tasks to the audit committee or set up an independent committee to oversee the investigation. You may want to set a schedule for reporting progress to the full board.

2 **Retain credible advisors:** Outside counsel is typically retained to conduct a thorough, investigation. By employing outside counsel, written and oral reports can be protected by attorney-client privilege or work product doctrine. Directors should consider the advantages of truly independent advisers, without close ties to the management involved, and whether the executive should be offered his or her own counsel. If experts, such as forensic accountants, are necessary, they should be hired by counsel to keep their work within the attorney-client privilege.

Common Mistakes To Avoid

- Delaying the start of an investigation, or failing to investigate additional or related reports
- Failing to consider external optics, including potential conflicts, with respect to oversight of review and outside advisers
- Inconsistent communications, external or internal, and delayed disclosures
- Ignoring root causes and related remediation

3 **Be on the lookout for additional or related whistleblower reports:** Once headline-catching allegations surface, others often follow. The board should ensure that the company's reporting hotline is properly monitored so that any related allegations are identified, escalated and investigated promptly, including any related past allegations.

At the same time, the scope of the investigation should be clearly defined to prevent mission creep.

4 **Determine what, if anything, the company must disclose and how:** Assess, with outside counsel, whether any disclosures are required to regulators, other authorities or investors. Consider, too, whether the company needs to delay any corporate activities such as bond offerings, stock repurchases or other transactions where the company must disclose any material non-public information, or represent that it has none.

The company may face multiple demands for information from a range of stakeholders, including employees, counterparties, shareholders, the media, etc. Responses should be consistent across multiple stakeholders, and accurate, and disclosure obligations should be monitored and reevaluated as new information becomes available. The management group "in the tent" on the issue must be selected to ensure that relevant divisions of the company are not going about business as usual where disclosure issues may need to be considered or could have an impact on the business Be wary of leaping to premature conclusions. Do not be afraid to say, "We don't know yet, but these are our priorities and values, and here's what we're doing."

5 **Don't forget about the auditors:** Directors must assess whether the nature of the allegations obligate them to make disclosures to the company's auditors or whether disclosures should be made as a matter of prudence. If details of the investigation are shared with the auditors, particular care must be taken to preserve the attorney-client privilege. At a time when auditors face increased scrutiny of their work by regulators and others, directors should anticipate that auditors may request details of any misconduct that could have an impact on a company's financial statements or the integrity of management involved in preparing and signing them.

6 **Develop a public relations strategy:** It is not always possible to keep these kinds of investigations confidential. The risk of leaks and/or the need for mandatory disclosures may tip the scales in favor of a public statement early in the investigation. At a minimum, the board should plan ahead for the possi-

bility of a leak. Premptive disclosure may allow the company to better control the narrative. The board, with outside counsel and potentially a trusted public relations consultant, should weigh the pros and cons of any public statements, develop a plan for their timing — and prepare to deviate from those plans and expedite disclosures if circumstances change. It is critical to have advisors with peripheral vision, not solely focused on legal ramifications, and consider how messages will be received by different stakeholders that are important to the company.

7 **Consider suspensions or recusals:** The board should consider whether it is necessary or appropriate, based on the type and severity of the allegations, to suspend the target of the allegations, or limit his or her authority or involvement in certain matters or business activities during the investigation.

Be on the lookout for additional or related whistleblower reports. Once headline-catching allegations surface, others often follow.

8 **Understand root causes:** As the investigation progresses, the board should focus not just on whether the allegations are substantiated, but also on analyzing any root causes of the purported issue. Early analysis of these issues will help frame remediation efforts and assist in deciding on any disciplinary action.

9 **Think ahead about remediation and disciplinary options:** If the allegations of misconduct are substantiated or concerns remain about the executive's conduct or integrity, the board will have to decide how to respond with regard to the executive. Options include decreased compensation, demotion or removal of the executive, and/or changes to the governance structure. If the board deems it necessary to remove the executive, it will need to plan for succession, too. Should the investigation reveal systemic problems, the board will need to address them, such as by enhancing the company's compliance program and internal controls, or possibly via changes to governance and disciplinary processes.

10 **Keep litigation risks in mind throughout:** If an investigation becomes public or the allegations of misconduct are confirmed, the board should expect civil suits by shareholders, any victims and, possibly, the executive at the center of the crisis. That prospect needs to be in the back of directors' minds from the earliest stages, and should inform the board's decisions along the way. Taking the right steps with counsel from the outset will help

to ensure that work product and reports related to the investigation are protected by legal privileges and do not need to be disclosed in any litigation.

Getting the first few days right will save your company time and money, and may help to minimize legal and regulatory risks, reputational injury and business disruption. It will also demonstrate to investors, employees, customers and counterparties that the company is well governed, has strong controls and is committed to compliance and ethical behavior.

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Interview: **Companies May Soon Gain Better Insight Into Their Shareholder Bases, and Insiders May Face New Restrictions on Scheduled Share Sales**

SEC veteran Raquel Fox explains how a bill in Congress would require investment funds to disclose their derivative holdings and what the SEC may do to address perceived abuses by directors and officers of pre-scheduled stock sales plans.

Introduction

Two proposed changes in securities regulations would have a direct impact on directors and boards.

The first involves the disclosures that asset managers must make about their holdings — crucial information for companies about who their shareholders are. A proposal would, for the first time, require the disclosures to include derivatives positions.

The other changes would involve pre-scheduled stock sales (10b5-1) plans, which allow insiders such as directors and executives to plan ahead to dispose of shares to avoid accusations that they are trading on material, non-public information.

Skadden's Ann Beth Stebbins interviews her fellow partner Raquel Fox about the changes. Before joining Skadden in January 2021, Ms. Fox held a number of leadership positions at the U.S. Securities and Exchange Commission (SEC) over the past decade, including serving as the director of the Office of International Affairs, senior adviser to then-Chairman Jay Clayton.

A bill in the House of Representatives would provide companies with more information about large stockholders. The law would, for the first time, require investment funds with more than $100 million in assets to disclose their derivatives positions on a quarterly basis, as well as their shareholdings. This would give companies information about their shareholder base that is not currently available from public sources.

Listen to discussion of fund disclosure requirements

Many companies have 10b5-1 plans for directors and officers, allowing them to sell stock on a preset schedule. The plans can be an affirmative defense to accusations of insider trading. The SEC is weighing several *changes to the regulations governing these plans to prevent perceived abuses — changes that might include a minimum waiting (or cooling off) period between the creation of the plan and the first trade and a limit on the number of plans a single person is allowed.*

Listen to discussion of 10b5-1 share sale plans

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Concerns About 10b5-1 Stock Sale Plans

Insiders may be "gaming" the rules and benefitting from material, non-public information about their companies when they set up pre-scheduled stock sales under a so-called 10b5-1 plan, according to a recent study of more than 20,000 such plans. Business school researchers at Stanford University, University of Washington and the University of Pennsylvania concluded that insiders use the plans "to engage in opportunistic, large-scale selling of company shares." Key findings include:

- Share sales under 10b5-1 plans tend to "avoid significant losses and foreshadow considerable stock price declines that are well in excess of industry peers."
- Nearly half (49%) of 20,000 plans studied covered a single trade.

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Antitrust Enforcement Takes a Sharp Left Turn

Progressives in the Biden administration are reshaping antitrust policy through key appointments and an executive order that aims to increase competition across the economy, not just in the tech sector. Expect more scrutiny of mergers and employment practices, in particular.

Over the past few years, a strong bipartisan consensus emerged in support of more aggressive antitrust enforcement. There has been a widespread view that enforcement, even during the Obama administration, has been too lax, resulting in higher levels of concentration and resulting harm to American consumers. Although competition in the technology sector has drawn the most attention, the concern extends across multiple industries. Senator Amy Klobuchar (D.-Minn.), a leading voice for stronger competition laws, said the problems range from "cat food to caskets."

Responding to this view, President Biden ordered department and agency heads to prioritize competition issues and he has named "progressives" to the two most important antitrust enforcement positions, where they are likely to press for a paradigm shift in policy. Business is already feeling the effects.

The new leaders of the FTC and Antitrust Division are committed to more aggressive enforcement.

Lina Khan, at age 32, is the youngest chair ever at the Federal Trade Commission (FTC). She made a name for herself with an article, "Amazon's Antitrust Paradox," that criticized Amazon and other big tech companies for allegedly abusing their monopoly positions. She has called for dramatic changes that would broaden the definitions of unlawful conduct and unlawful mergers, and focus more on protecting workers and advancing social justice. Since she was confirmed in June 2021, the FTC has taken a number of actions that portend more aggressive enforcement, including promises to revise the FTC's Horizontal Merger Guidelines; outright repeal of the Vertical Merger Guidelines, most likely in favor of guidance that will increase scrutiny of those deals; letters warning companies of ongoing investigations of mergers even after expiration of the Hart-Scott-Rodino Act (HSR) waiting period; and new rules to curb anti-competitive behavior.

In merger reviews, the FTC is now asking about the deal's impact on labor markets, the possibility that a merger might lower costs so much that other companies won't be able to compete effectively and, where the buyer is an investment firm, what consequences that may have.

Jonathan Kanter, the nominee to head the Antitrust Division of the Department of Justice (DOJ), has not been as outspoken as Kahn, and he spent 20 years in prominent law firms in New York representing large corporations. But he formed his own firm in 2020 specializing in representing plaintiffs with antitrust claims against big tech companies, and recently he has spoken publicly about the need for strong antitrust enforcement and criticized tech companies for stifling competition. When he is confirmed, he is expected to adopt a pro-enforcement stance similar to Khan's.

Mergers are likely to receive closer scrutiny, but the shift is unlikely to have a chilling effect on dealmaking.

Some deals are certain to be questioned more closely, and there will be more uncertainty and longer investigations, but tough deals can still get done with the right strategy.

The new leaders at the FTC and DOJ will look to challenge more deals and have signaled they may be less willing to accept divestitures and behavioral remedies to resolve concerns. The shift in emphasis is already reflected in the questions posed in merger reviews. Regulators have asked companies about their deals' impact on labor issues, power-buyer concerns and even "anticompetitive efficiencies" (the possibility that a merger might lower costs so much that other companies won't be able to compete effectively), a notion that runs contrary to accepted antitrust doctrine. And very recently the new Bureau of Competition Director at the FTC outlined new steps the agency will take to increase the types of information sought in merger investigations (*e.g.*, the deal's impact on labor markets, cross-market effects and the potential consequences where investment firms are buyers) and to make merging parties' compliance with second requests (the broad document and data requests issued by the agencies) even more difficult and time-consuming.

But, ultimately, to block a merger, U.S. antitrust enforcers must convince a federal judge of the merits of their case. While the FTC and DOJ have decent track records prevailing at trial, especially for traditional, horizontal deals with high market shares, they have been far less successful when they try to push the envelope, for example, by challenging vertical deals or the acquisition of "nascent" competitors. So, unless Congress decides to lower the bar for blocking a merger, which appears unlikely, the FTC and DOJ will have to argue in court based on existing laws and precedent.

The agencies are also constrained by resources, because litigating mergers is costly. Expert witnesses must be paid and the suits require large teams of staff lawyers and economists. Traditionally, each agency has only been able to litigate a handful of cases at any given time. They simply cannot go to court to block every deal they oppose.

In this changed environment, the right strategy will be critical when defending your deal. For mergers with significant issues, parties should expect to receive and comply with a second request for documents. Compliance with the second request, which restarts the HSR waiting period, can be the only real leverage that parties have because it allows them to "put the agencies to their proof," forcing the regulators to decide whether to let the transaction proceed or file suit to block it, absent a fix. Simply waiting to try to convince the agencies on the merits without putting them on the clock will likely be a losing strategy for more transactions.

For the toughest deals, it will be important to demonstrate that your company is willing to defend the transaction in court. This will likely require tweaks to your merger agreement, including in the antitrust-efforts clause and the drop-dead date, to provide for the possibility that litigation may extend the timeline. For deals that also require foreign antitrust approvals, it will be even more important to coordinate efforts and set a global strategy.

President Biden's executive order promoting competition extends far beyond the FTC and DOJ and has already led to measures far afield from technology.

The president's sweeping July 9, 2021 Executive Order directing departments and agencies to reassess their policies and regulations with an eye to fostering greater competition created a mandate across the government and across the economy.

Industries identified in the order include airlines, healthcare, agriculture, transportation, internet services, technology and finance. Since the order, the Department of Transportation has announced that it will grant greater access to low-cost carrier airlines during peak hours at Newark Airport in order to boost competition, and the DOJ recently challenged an alliance between Jet Blue and American Airlines. Other agencies, such as the Department of Health and Human Services, the Federal Maritime Commission, the Food and Drug Administration, the Federal Communications Commission and the Consumer Financial Protection Bureau are seeking input while they contemplate reforms to try to improve competition.

Expect to see more attention focused on the labor market.

Enhanced antitrust scrutiny of human resources practices dates back to the end of the Obama Administration, when the Antitrust Division and the FTC jointly warned that "naked" no-poach agreements between employers (*i.e.*, not linked to a transaction or collaboration) and wage-fixing agreements where employers agree not to engage in pay competition would be treated like price-fixing and market allocation agreements, which are *per se* antitrust violations, and would be criminally prosecuted.

The DOJ recently announced several indictments involving wage-fixing conspiracies and no-solicitation agreements, and we expect there will be more, as President Biden specifically called for restrictions on no-poach agreements.

Such arrangements have also given rise to class action antitrust litigation in industries ranging from technology to franchise restaurants and poultry production. If the administration pursues more enforcement actions in labor markets, more civil litigation will surely follow.

Strong bipartisan support for revisions to antitrust laws hasn't yet translated into new legislation, and the outlook is unclear.

At the same time the executive branch is taking a more activist approach to antitrust, almost two dozen proposed bills have been introduced in the House and Senate to reform key statutes. Some would

Takeaways

- Biden's DOJ and FTC appointees appear committed to major changes in enforcement priorities and practice.
- The administration's stress on promoting competition extends across the economy, not just to the technology sector.
- Many mergers will receive more scrutiny, but unless Congress amends the antitrust laws, the change in approach to enforcement should not have a major impact on dealmaking.
- Labor market practices such as no-poach agreements and coordination by employers of employee compensation will receive more attention.

make modest changes (*e.g.*, raising HSR merger review fees, lowering HSR thresholds and increasing enforcement budgets), while others take a more aggressive approach (*e.g.*, prohibiting specific conduct by large online platforms and pharma companies, breaking up online platforms, prohibiting deals by large companies and lowering the standard by which mergers and conduct are judged unlawful).

With so many competing legislative priorities, and uncertainty about which measures may garner support, the fate and timing of these bills is not clear.

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This Isn't Your Grandparents' Books and Records Demand

As plaintiffs have switched litigation strategies and Delaware courts have expanded stockholders' rights to seek company records, boards need to be mindful of the changes and assess the way they communicate and record board decision-making.

The right of stockholders to seek corporate books and records is a well-established feature of corporate law in Delaware, where most big American companies are incorporated. But the number of statutory records demands has spiked in recent years, and the scope of the requests has broadened, as Delaware courts have limited companies' defenses and taken companies to task for aggressively resisting shareholder requests.

For boards and their companies, this has potential consequences. Stockholders, many with an eye toward litigation, are sometimes able to access emails, texts and other material through a records demand that can lay the grounds for a suit. What used to be a simple matter of granting access to formal, board-level books and records reflecting board decisions now has the potential to be more expansive and disruptive if casual communications that directors and executives assumed would not be part of the "official" corporate records are revealed to potential adversaries.

Below is a primer for directors on the evolving nature of these requests and what it means for boards.

What Has Changed

Section 220 of the Delaware General Corporation Law allows stockholders to access to corporate books and records for a "proper purpose" — most commonly to "investigate wrongdoing" such as a possible breach of fiduciary duty by the board or management. The stockholder must demonstrate a "credible basis" for suspecting wrongdoing or mismanagement, but that threshold has generally been considered a low hurdle to overcome.

In the past, courts gave companies some leeway to push back where it appeared the stock holders were just fishing for evidence on which to base a suit, with no meaningful prospect for success, and they were reluctant to force companies to turn over anything other than board-level materials, such as minutes, presentations and the like.

However, as recent Delaware decisions made it harder for stockholders to sue to block a merger, stockholders have resorted more frequently to books and records demands in order to obtain evidence they can use as the basis for damages actions brought after mergers are completed. That, in turn, has spawned litigation over the scope of Section 220, and Delaware courts have construed it broadly and restricted the grounds on which corporations can limit or refuse the requests.

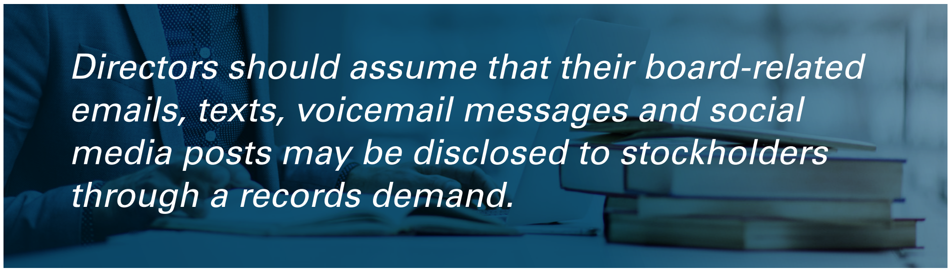
Here are answers to some questions directors may have:

1 Aren't "books and records" limited to formal board-level records like minutes?

No. Increasingly, the Delaware courts are open to giving stockholders access beyond formal board materials such as minutes and board decks, particularly when a company has a history of not complying with corporate formalities. For example, a recent Delaware Supreme Court decision held that, in some circumstances, electronic communications may be "necessary and essential" for purposes of a books and records demand. In nearly every Section 220 demand since, stockholders have sought electronic communications. The courts have indicated that a corporation should not be required to produce electronic communications if other materials such as board minutes and decks exist and would satisfy the stockholder's "proper purpose" in making the demand. However, if a company and its board conduct business informally over email and other electronic media, instead of in the boardroom and at board meetings where minutes are taken, or where the formal board materials lack the relevant information, electronic information may be considered essential to the plaintiff's investigation. No hard and fast rule has emerged from the cases, but Delaware judges are willing to allow access to informal communications in these situations.

2 Documents produced as part of a Section 220 demand will remain non-public and strictly confidential, right?

Generally speaking, yes, but not always. The Delaware courts have said that confidentiality is not presumed in Section 220 productions, but the courts have typically been amenable to allowing companies to protect the records through confidentiality agreements, and by redacting privileged attorney-client communications. If the stockholder ends up filing a lawsuit based on the records, the confidentiality agreements usually



Directors should assume that their board-related emails, texts, voicemail messages and social media posts may be disclosed to stockholders through a records demand.

require them to be filed under seal, consistent with court rules. However, a public version will eventually become available, and only truly confidential information — such as trade secrets or other sensitive material business or personal identifying information — will remain under seal.

3 Can a company "just say no" to these Section 220 demands?

Generally, not. Delaware courts have recently expressed frustration with overly aggressive company responses to Section 220 demands. In a July 2021 ruling, where a company refused to engage with the stockholders who had clearly identified a credible basis to investigate wrongdoing, and the company failed to offer a single document before litigation commenced, the Delaware Court of Chancery ordered the company to pay the stockholders' hefty fees in pursuing the demand.

By contrast, in another case, a court commended the parties for acting reasonably and resolving many issues on their own, leaving it to the court only to decide on the exact scope of documents to be produced. The takeaway is that judges like to see corporations try to resolve Section 220 demands amicably before the matter spills into court.

4 What defenses can a company raise in fighting a books and records demand?

In a significant shift, the Delaware Supreme Court said in December 2020 that companies cannot resist a records demand on the ground that the alleged mismanagement or wrongdoing could not, if raised in a subsequent complaint, withstand a motion to dismiss. And a stockholder does not have to specify the precise ends to which they might use any books or records.

Some defenses remain, however, including technical compliance with the statute and whether or not the stated purpose of the demand is the true purpose. Companies can also still challenge the stockholder's standing to make a demand and the scope of the request.

5 What can a company do to better position itself to respond to a potential Section 220 demand?

– There's no way to guarantee that emails or texts will not have to be produced in response to a Section 220 demand. With the

- changing law, it is vital to assess your corporation's policies and procedures governing board-level record-keeping.
- The board's use of electronic communications for discussions and decision-making deserves particular attention. Directors should consider limiting written electronic communications within the board to formal communications. Ideally, directors should avoid quick, informal emails or text messages about material matters.
  - Substantive discussions are better suited for calls and meetings, and electronic communications are best used for logistical purposes, such as scheduling.
  - Board members may also want to consider communicating only through authorized means, such as a board portal or dedicated email accounts. If directors use personal email accounts, or those of other companies with which they are affiliated, for board-level communications, those accounts may be accessed if a court finds that necessary to satisfy a records demand.
  - It is also important to consider the tone and content of all written communications. A good rule of thumb, before texting or emailing, is to ask, "Would you want to read this in a newspaper?"

The bottom line is that directors should assume that their business-related communications — including those in emails, texts, voicemail messages, social media posts, etc. — might be made available to stockholders through a records demand, even if there is no litigation yet. But maintaining current, consistently enforced internal policies regarding board-level communications can help limit the risk that the company will have to turn over informal communications that might be misinterpreted or unfairly used against the company.

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