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Caremark Liability Following the SEC's New ESG Reporting Requirements

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Recent developments in the Court of Chancery concerning a corporate board's duty to monitor and provide oversight over a corporation's operations, so-called *Caremark* claims, are likely to intersect with the Securities and Exchange Commission's ("SEC") proposed new ESG disclosure obligations to create a new category of corporate risk. In this article, we discuss the recent trends in Delaware law that have led to a revitalization of *Caremark* and the SEC's current proposals for enhanced ESG disclosure, the intersection of which can be expected to result in litigation and other corporate risk, and some commonsense steps corporations can take to mitigate this potential new category of risk.

The* "Caremark" *Doctrine

One of the more notable developments in Delaware case law in recent years has been the revitalization of *"Caremark* duty" claims. *Caremark* actions traditionally were notoriously difficult to plead—in explaining the doctrine, the Chancery Court famously called it "the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d 959, 967 (Del. Ch. 1996). In recent years, however, the Delaware courts have breathed new life into the *Caremark* doctrine by allowing these types of claims to proceed to discovery.

Specifically, the *Caremark* doctrine was returned to potency in 2019 following the Delaware Supreme Court's decision in *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019). Although *Marchand* did not change the *Caremark* standard, it demonstrated the Delaware courts' greater willingness to permit *Caremark* claims to pass the motion to dismiss phase if they could be plausibly pled. Marchand ultimately laid the groundwork for a number of subsequent rulings demonstrating the renewed vitality of *Caremark* claims—not only have at least four *Caremark* suits survived a motion to dismiss since *Marchand,* but there are also several ongoing *Caremark* suits in Delaware.

Under *Caremark,* there are two distinct types of claims. The first type concern a board's failure to implement a system of controls to prevent some unlawful misconduct that occurred. The second type of claims concern a failure to monitor by the directors. It is imperative, therefore, that boards focus on: (1) establishing adequate information and reporting systems to monitor "mission critical" aspects of their company's business; and (2) monitoring those systems once in place.

The SEC's Proposed New Climate-Related Disclosures

On March 21, 2022, the SEC proposed new rules requiring companies to report extensive line-item disclosures on climate-related ESG issues, entitled: "The Enhancement and Standardization of Climate-Related Disclosures for Investors." If implemented as written, the proposed rules would require registrants to make significant additional disclosures regarding the impact of climate-related risks on their business.

Among other things, under the proposed rules, registrants would be required to disclose:

1. Greenhouse gas ("GHG") emissions, regardless as to whether those emissions are deemed material by the company. Emissions would now be reported by "scope" or type.

2. "Climate-related risks" that are "reasonably likely to have a material impact," including climate-related conditions and events that impact financial statements, business operations, or value chains.

3. Governance disclosures related to climate risk, including how the board and management assess and manage these climate-related risks.

4. Any targets or goals related to the reduction of GHG emissions.

These proposed new rules are part of the Biden Administration's efforts to "advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk." Yet the sheer breadth, specificity, and complexity of the proposed rules would result in one of the most profound changes to public companies' disclosure obligations in the history of the SEC.

Additional Caremark *Exposure*

The SEC's climate-related disclosure rules will likely fuel ESG-related *Caremark* claims. In particular, heightened disclosure requirements will provide ammunition for derivative or class action lawsuits and may expose companies to specific indirect risks, including heightened exposure to pre-suit discovery and proxy contests.

Direct Litigation Risk

The SEC's new reporting requirements are likely to create new grounds for investors to assert liability claims against corporations and their boards of directors and management. Shareholders can be expected to leverage the new disclosures to seek to hold companies accountable for failing to properly oversee, mitigate or eliminate climate-related risk. The revitalized *Caremark* doctrine is likely to be employed to allege boards and managers failed to oversee so-called “mission-critical” aspects of their business that generate climate-related risk.

In this vein, plaintiffs may choose to use disclosures required by the SEC’s proposed rules as the basis for a breach of duty to monitor or *Caremark* claim through either a derivative suit, brought on behalf of the company against its directors and officers, or a class action suit, brought on behalf of a class of injured shareholders or investors. *Caremark* claims will likely arise if and when a board fails to exercise proper oversight with respect to climate-related risks or to consider proper mitigating steps. This new threat will be amplified for companies that (i) have yet to fully examine how ESG issues factor into their mission-critical operations or (ii) have yet to devote resources and personnel to measuring (using consistent, comparable and reliable data) and analyzing their own ESG-related risks. Companies need to be able to ascertain *and* address their most pressing ESG-related risks to avoid future *Caremark* liability.

Indirect Risks

Indirect risks from the proposed new disclosure regime may manifest in a variety of ways.. They can result in the disclosure of embarrassing or harmful information about a company, its board, or managers, and lead to the replacement of key company executives or directors by aggrieved shareholders. Moreover, they give rise to issues that are expensive and resource-intensive to address. While these risks are indirect to companies, they pose a direct threat to board members and managers.

Pre-Suit Discovery. Boards can expect new disclosure requirements to enable shareholders to gain greater access to pre-suit discovery. Section 220 of Delaware’s General Corporate Law provides shareholders with a qualified right to inspect a company’s books and records for suspected corporate wrongdoing or mismanagement, and need only demonstrate a “credible basis” to proceed. The new ESG reporting requirements will likely provide shareholders with even more information as ammunition to fuel Section 220 demands. Opening a company’s books to pre-suit discovery could expose boards, management, or companies to serious reputational harm, as well as provide fodder for future lawsuits against the current board.

Proxy Contests. New ESG-related disclosures are also likely to generate greater turmoil in the form of proxy battles at the board level. Historically, shareholder activists have been focused on addressing short-term profit, stock price and total shareholder return. Yet activist campaigns containing an environmental or social objective have doubled as a proportion of campaigns overall during the five years between 2016 and 2021, including a successful campaign against Exxon to place directors on its board. The proliferation of new ESG reporting requirements is expected to further fuel these contests, particularly with respect to companies that are perceived to be lagging on ESG commitments or expectations.

Avoiding Environmental-**Caremark** ***Claims***

Companies should take several steps in preparation for the increased pressure expected to arise from the need to address ESG issues.

First, companies should be aware of the obligations and risks they face with regard to ESG issues. That means determining what ESG-related risks could detrimentally impact a “mission-critical” aspect of a company’s business. What is determined to be “mission-critical” will necessarily vary by company.

Second, once companies are cognizant of the ESG-related risks they face, they will need to start implementing appropriate governance structures so that they are aware of, and can take steps to address, ESG risks. Directors should establish responsible committees and internal information and reporting procedures to ensure board members have proper oversight of these efforts. This will allow boards to demonstrate their engagement in response to potential *Caremark* claims, as well as to respond to any ESG risks arising in the company's operations.

Third, with these governance structures in place, companies must focus on generating, collecting, and analyzing consistent and comparable data on the ESG-related risks they face. These data should be actively monitored by managers and board members so they can identify and address ESG risks before they result in catastrophic situations and resulting litigation. And, if *Caremark* claims ensue, boards will be able to use these governance structures and reporting regimes to demonstrate that they have satisfied their oversight obligations.

Finally, once these systems are in place, companies should take steps to prepare for the adoption of the SEC's new climate-related disclosure requirements. The development of governance and reporting structures will undoubtedly aid in the collection of information for these purposes. While taking these steps, it is advisable that corporate executives and boards seek input from subject matter experts and experienced legal counsel to help design and implement robust compliance and monitoring regimes that can help to discourage or forestall future litigation in the form of *Caremark* or other claims related to ESG issues.

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