# INSIGHTS

The Corporate & Securities Law Advisor

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*The Corporate & Securities Law Advisor*

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PROXY SEASON POINTERS

# Recent SEC Rulemaking: Compliance and Implementation Tips

***By Cam Hoang***

The Securities and Exchange Commission (SEC) has been on a rulemaking spree, finalizing rules on the governance and disclosure of pay versus performance in executive compensation (August 2022), clawbacks of incentive-based compensation in the event of certain accounting restatements (October 2022), Rule 10b5-1 and similar trading arrangements and insider trading policies (December 2022) and cybersecurity incident reporting and risk management, strategy, and governance (August 2023).

As a result, reporting companies are re-examining board and management oversight of these topics and related controls and procedures, which are subject to quarterly certification by the CEO and CFO. The examination should be an iterative process, instead of a one-time exercise, as regulatory requirements and prevailing practices continue to evolve. These processes may require updates to governance documents, including board and committee agendas, committee charters, and corporate governance principles. They may also prompt updates to related disclosure in proxy statements and annual reports.

AQ: Spell out TSR

AQ: Spell out SCT

| Compliance Deadlines for Calendar Year-End Companies | Disclosure & Implementation |
|---|---|
| *Pay versus Performance*<br>Include three fiscal years in the 2023 annual meeting proxy statement, adding another year of disclosure in each of the two subsequent annual proxy filings that require this disclosure. | *Annual Disclosure*:<br>• Pay-versus-Performance Table with (1) financial performance measures (including TSR, peer TSR, net income and the most important Company Selected Measure (CSM)) and (2) compensation for CEO and average of other NEOs (as reported in the SCT and as "actually" paid;<br>• Clear description (in narrative and/or graphics) of relationships between (1) each of the financial performance measures included in the table and the executive compensation actually paid and (2) the issuer's TSR and its peer group TSR; and<br>• Unranked, tabular list of the three to seven most important financial performance measures used by the issuer, including the CSM.<br>Sources: Schedules 14A and 14C, and Items 402(v) and 405 of Regulation S-K<br><br>*Governance and Implementation Tips*:<br>• Review pay versus performance calculations and disclosure, including decision on CSM.<br>• Consider supplemental disclosure, such as realized/realizable pay tables, to help investors understand how the company approaches pay vs performance.<br>• Consider potential changes to executive compensation program as a result of the analysis. |

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| Compliance Deadlines for Calendar Year-End Companies | Disclosure & Implementation |
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| *Clawbacks: Listing Standards for Recovery of Erroneously Awarded Compensation*<br><br>Policies effective for incentive-based compensation received on or after October 2, 2023<br><br>Adopt a compliant clawback policy by December 1, 2023<br><br>File the clawback policy as Exhibit 97 of Form 10-Ks beginning with the fiscal year ending December 31, 2023<br><br>Subsequent disclosure triggered by financial statement corrections and restatements, on Form 10-K cover page and Part III (can be incorporated by reference from proxy statement) | *Annual Disclosure*: An issuer must file its policy as an Exhibit 97 to its annual report and, if applicable, disclose in its annual report or proxy statement how it has applied the policy, including, as relevant:<br><br>• For each restatement:<br>— The date on which the issuer was required to prepare an accounting restatement;<br>— The aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement, including an analysis of how the amount was calculated;<br>— If the financial reporting measure related to a stock price or TSR metric, the estimates that were used in determining the erroneously awarded compensation attributable to such accounting restatement and an explanation of the methodology used for such estimates;<br>— The aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed fiscal year; and<br>— If the aggregate dollar amount of erroneously awarded compensation has not yet been determined, disclose this fact, explain the reason(s).<br>• If recovery would be impracticable, for each current and former named executive officer and for all other current and former executive officers as a group, disclose the amount of recovery forgone and a brief description of the reason the listed issuer decided in each case not to pursue recovery; and<br>• For each current and former named executive officer from whom, as of the end of the last completed fiscal year, erroneously awarded compensation had been outstanding for 180 days or longer since the date the registrant determined the amount the individual owed, disclose the dollar amount of outstanding erroneously awarded compensation due from each such individual.<br>• If at any time during or after its last completed fiscal year the issuer was required to prepare an accounting restatement, and the registrant concluded that recovery of erroneously awarded compensation was not required pursuant to the registrant's compensation recovery policy, briefly explain why application of the recovery policy resulted in this conclusion.<br><br>Issuers must indicate by check boxes on their Form 10-Ks whether the financial statements included in the filings reflect a correction of an error to previously issued financial statements and whether any such corrections are restatements that require a recovery analysis.<br>Sources: Rule 10D-1 and related listing standards; Schedule 14A; Items 402(w), 404, 405 and 601 of Regulation S-K; Form 10-K, Form 40-F, Form 20-F and Form N-CSR<br><br>*Governance and Implementation Tips*:<br>• Define scope of clawback policy, including covered individuals and compensation subject to recovery. |

| Compliance Deadlines for Calendar Year-End Companies | Disclosure & Implementation |
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| | • Consider whether to adopt one publicly filed policy or separate policies, one with enhanced clawback features that is not subject to filing.<br>• Identify a primary administrator for the policy, either the board or a committee such as the compensation committee.<br>• Obtain signed acknowledgements and/or amend employment agreements and incentive plans to enhance enforceability of the policy.<br>• Consider a tabletop exercise to road-test issues such as identifying a triggering restatement and calculating compensation subject to clawback. |
| *Share Repurchase Disclosure Modernization*<br>For domestic issuers: Include quarterly disclosure in Part II and Exhibit 26 of Form 10-Qs and 10-Ks beginning with the Form 10-K for the fiscal year ending December 31, 2023<br><br>For foreign private issuers (FPIs): Include daily activity disclosure in quarterly Form F-SRs beginning with the quarter ending June 30, 2024; include the narrative disclosure in Form 20-Fs filed after the first Form F-SR has been filed.<br><br>For Listed Closed-End Funds: Include semi-annual disclosure in Form N-CSRs beginning with the first six-month period that begins on or after January 1, 2024. | *Narrative Disclosure:*<br>• The objective or rationale for share repurchases and process or criteria used to determine the amount of repurchases;<br>• The number of shares (or units) purchased other than through a publicly announced plan or program, and the nature of the transaction;<br>• For publicly announced repurchase plans or programs:<br>— The date each plan or program was announced;<br>— The dollar amount (or share or unit amount) approved;<br>— The expiration date (if any) of each plan or program;<br>— Each plan or program that has expired during the period covered by the table in Exhibit 26; and<br>— Each plan or program the issuer has determined to terminate prior to expiration, or under which the issuer does not intend to make further purchases.<br>• Any policies and procedures relating to purchases and sales of the issuer's securities by its officers and directors during a repurchase program, including any restriction on such transactions; and<br>• The issuer's adoption, modification or termination of Rule 10b5-1 trading arrangements.<br><br>*Daily Activity Disclosure*: Tabular disclosure of repurchase activity aggregated on a daily basis and disclosed either quarterly or semi-annually:<br>• Class of shares purchased;<br>• Average price paid per share;<br>• The total number of shares purchased, including the total number purchased as part of a publicly announced plan;<br>• The aggregate maximum number of shares (or approximate dollar value) that may yet be purchased under a publicly announced plan;<br>• The total number of shares purchased on the open market;<br>• The total number of shares purchased in reliance on the safe harbor in Rule 10b-18; and<br>• The aggregate total number of shares purchased pursuant to a 10b5-1(c) plan.<br><br>Issuers will also be required to include a checkbox preceding its tabular disclosures indicating whether certain officers and directors purchased or sold shares that are the subject of an issuer share repurchase plan or program within four business days before or after the announcement of that plan or program. |

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| | Sources: Items 405, 408, 601 and 703 of Regulation S-K; Rule 13a-21; Forms F-SR, 20-F, 10-Q, 10-K and N-CSR<br><br>*Governance and Implementation Tips*:<br>• Develop a quarterly process to collect, audit and report share repurchase information on a daily basis.<br>• Develop a quarterly process to track and disclose the adoption, modification and termination of Rule 10b5-1 plans entered into by the issuer.<br>• Discuss the objectives or rationales for issuer's share repurchases and the process or criteria used to determine the amount of repurchases, which may vary from quarter to quarter.<br>• Consider policies and procedures relating to purchases and sales of the issuer's securities during a repurchase program by its officers and directors, including any notification requirements for, or restrictions on, such transactions.<br>• Develop a process for identifying insider transactions within four business days before or after share repurchase program announcements and consider whether |
| *Insider Trading Arrangements and Related Disclosures*<br>Amended conditions for Rule 10b5-1 plans effective February 27, 2023<br><br>Check box for Rule 10b5-1 transactions on Form 4s and 5s filed on or after April 1, 2023<br><br>Report gifts on Form 4s within two business days, on or after April 1, 2023<br><br>Disclose adoption, modification or termination of trading arrangements on Form 10-Qs and 10-Ks beginning with the Form 10-Q for the quarter ending June 30, 2023 (Form 10-K for the fiscal year ending December 31, 2023 for smaller reporting companies (SRCs))<br><br>File insider trading policies on Exhibit 19 of Form 10-K, beginning with the Form 10-K for the fiscal year ending December 31, 2024<br><br>Disclose adoption of insider trading policy, or explain absence, in annual meeting proxy statements, beginning in 2025<br><br>Include tabular and narrative disclosure of option awards close in time to release of MNPI and related grant policy in annual meeting proxy statements, beginning in 2025 | *Disclosure*:<br>• Quarterly disclosure regarding the adoption, modification or termination of Rule 10b5-1 plans and certain other written trading arrangements by directors and officers for the trading of issuer securities;<br>• Annual disclosure of insider trading policies and procedures as Exhibit 19 of Form 10-K;<br>• Annual tabular and narrative disclosure regarding awards of options close in time to the release of material nonpublic information and related policies and procedures;<br>• Section 16 filers indicate by checkbox whether a reported transaction was intended to satisfy the affirmative defense conditions of Rule 10b5-1(c); and<br>• Section 16 filers disclose bona fide gifts of securities within two business days on Form 4s.<br>Sources: Items 402, 405, 408 and 601 of Regulation S-K; Rule 10b5-1; Schedule 14A; Rule 16a-13; Forms 4 and 5; Forms 20-F, 10-Q and 10-K<br><br>*Governance and Implementation Tips:*<br>• Review and approve updated policies and procedures for insider trading, Rule 10b5-1 plans and option grants, in light of new conditions for the availability of Rule 10b5-1(c)(1) affirmative defenses to insider trading by directors and officers.<br>• Develop a quarterly process to track and disclose the adoption, modification or termination of Rule 10b5-1 plans and similar trading arrangements entered into by directors and officers.<br>• Discuss timing of option grants in relation to Form 10-Q/10-K/MNPI 8-K filings and whether the company is prepared to "check the box" for grants made in the four business days before or one business day after the announcement. |

| Compliance Deadlines for Calendar Year-End Companies | Disclosure & Implementation |
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| *Cybersecurity Risk Management, Strategy and Governance*<br>Domestic filers and 20-F filers: Disclose risk management, strategy and governance in Part I of Form10-Ks and Item 16K of Form 20-Fs, beginning with the form for the fiscal year ending December 31, 2023<br><br>Domestic filers, 20-F filers and 40-F filers: Disclose cyber incidents in Item 1.05 of Form 8–K or in Form 6–K, beginning on December 18, 2023. SRCs on June 15, 2024. | *Governance Disclosure*: Enhanced and standardized disclosure on cybersecurity risk management, strategy, and governance in annual reports:<br>• Describe their processes, if any, for assessing, identifying, and managing material risks from cybersecurity threats, as well as whether any risks from cybersecurity threats, including as a result of any previous cybersecurity incidents, have materially affected or are reasonably likely to materially affect the registrant.<br>• Describe the board of directors' oversight of risks from cybersecurity threats and management's role and expertise in assessing and managing material risks from cybersecurity threats.<br>• Form 6-K will be amended to require foreign private issuers to furnish information on material cybersecurity incidents that they make or are required to make public or otherwise disclose in a foreign jurisdiction to any stock exchange or to security holders.<br>• Form 20-F will be amended to require that foreign private issuers make periodic disclosure comparable to that required in new Regulation S-K Item 106.<br><br>*Incident Disclosure*: Current reporting about material cybersecurity incidents on Form 8-K Item 1.05 (within four business days after the issuer determines it has experienced a material cybersecurity incident):<br>• Describe the material aspects of the nature, scope, and timing of the incident, as well as the material impact or reasonably likely material impact of the incident on the registrant, including its financial condition and results of operations.<br>• Issuers must determine the materiality of an incident without unreasonable delay following discovery and, if the incident is determined material, file an Item 1.05 Form 8-K generally within four business days of such determination.<br>• The disclosure may be delayed if the United States Attorney General determines that immediate disclosure would pose a substantial risk to national security or public safety and notifies the Commission of such determination in writing. If the Attorney General indicates that further delay is necessary, the Commission will consider additional requests for delay and may grant such relief through possible exemptive orders.<br>Sources: Items 106, 405 and 601 of Regulation S-K; Form S-3, Rules 13a-11 and 15d-11; Forms 20-F, 6-K, 8-K and 10-K.<br><br>*Governance and Implementation Tips*:<br>• Review incident response plans and cyber policies versus best practices and prevailing industry practices.<br>• Ensure that the relevant personnel are informed and involved on a timely basis to ensure that critical determinations can be made and incidents appropriately elevated.<br>• Use tabletop exercises to help board and management prepare for future incidents. |

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| Compliance Deadlines for Calendar Year-End Companies | Disclosure & Implementation |
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| | • Articulate criteria for materiality assessments under relevant disclosure regimes and apply them in tabletop exercises.<br>• *Identify and plan for compliance with relevant agencies' cyber regulation regimes.*<br>• Adopt and document related disclosure controls and procedures.<br>• Confirm that policies and procedures are implemented in a manner that can be audited.<br>• Confirm that agreements governing third party relationships provide issuer with the ability to obtain the information necessary to make prompt assessment and disclosure of cybersecurity incidents.<br>• Test insider trading policies and processes to ensure that the issuer is prepared to identify those individuals whose trading should be restricted in the event of a material incident and to communicate those restrictions without unreasonable delay.<br>• Educate management about their role in assessing and managing the issuer's material risks from cybersecurity threats. Provide access to outside experts.<br>• Educate board and its committees on their role in overseeing risks from cybersecurity threats and involve them in the establishment of systems to manage these risks. Provide access to outside experts.<br>• Consider the allocation of oversight responsibility at the board and committee level.<br>• Regularly update management and the board about cyber risk management and cyber incidents. |

GENERATIVE AI

# White House Issues Comprehensive Executive Order on Artificial Intelligence

***By Marc S. Martin, Alexander O. Canizares, Elizabeth Mendoza, and Tyler Robbins***

The White House recently issued its most extensive policy directive yet concerning the development and use of artificial intelligence (AI) through a 100-plus-page Executive Order (EO) titled "Executive Order on the Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence" and accompanying "Fact Sheet" summary.[1]

Following in the footsteps of last year's Blueprint for AI Bill of Rights and updates to the National Artificial Intelligence Research and Development Strategic Plan published earlier this year, the EO represents the most significant step yet from the Biden administration regarding AI.[2] Just as previous efforts, the EO acknowledges both the potential and the challenges associated with AI while setting a policy framework aimed at the safe and responsible use of the technology, with implications for a wide variety of companies. The EO also signals the government's intentions to use its purchasing power to leverage Responsible AI and other initiatives, with significance for government contractors.

As a unilateral action of the executive branch, this EO cannot alter existing laws or appropriate funds (both of which would require Congressional approval). Rather, the EO primarily provides guidance and directives to federal agencies and, more broadly, outlines the administration's policies and priorities on AI. The EO places a strong emphasis on inter-agency coordination, international collaboration, and a multistakeholder approach to navigate the complexities of AI.

Importantly, the EO also establishes requirements and expectations of the federal government relating to AI technologies procured through government contracts. Through these directives, the EO aims to promote innovation, protect individuals' rights, and establish the United States as a leader in the global AI landscape while addressing the inherent risks and challenges posed by AI technologies.

## Eight Guiding Principles

The EO emphasizes advancing and governing AI development and use based on eight guiding principles, summarized below. Federal agencies are instructed to adhere to these principles while considering views from a wide range of stakeholders including industry, academia, labor unions, and international allies.

1. **Safety and Security.** The EO directs agencies to ensure AI systems are reliable and secure, with robust evaluations and risk mitigation strategies. This includes directing the National Institute of Standards and Technology (NIST) within the US Department of Commerce to establish mechanisms for testing and monitoring AI systems both before and after deployment, with a particular emphasis on generative AI and "dual-use foundation models" (defined as large, general-purpose models that excel at "tasks that pose a serious risk to security, national economic security, national public health or safety"). Additionally, the EO directs agencies to explore potential mechanisms (for

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example, watermarking) and develop guidance to help Americans identify AI-generated content.

2. **Innovation and Competition.** The EO emphasizes fostering a competitive AI ecosystem, including by developing the US AI workforce and promoting investments in AI-related education, training, and research. It also directs agencies to address potential intellectual property challenges posed by AI, such as through directing the US Patent and Trademark Office to issue guidance on the patentability of AI technologies and AI-assisted inventions.Additionally, with the aim of promoting competition, the EO mandates that all agencies developing AI policies and regulations (particularly emphasizing the Federal Trade Commission [FTC]) use their existing authorities to promote a competitive AI marketplace, including taking steps to prevent dominant market players from disadvantaging competitors and providing new opportunities for small businesses and entrepreneurs.
3. **Workforce Support.** The EO instructs federal agencies, such as the US Department of Labor (DOL) and US Department of Education, to consider the impact of AI on the workforce and promote job training, education, and other measures to assist workers, particularly those displaced by advancements in AI technologies.
4. **Equity and Civil Rights.** Building on the Biden administration's efforts with the Blueprint for AI Bill of Rights, the EO mandates that AI policies support the administration's goals of advancing equity and civil rights and combating the spread of bias and discrimination through use of AI technologies. For example, the EO targets use of AI technologies in the criminal justice system, directing the attorney general to collaborate with various federal agencies to develop guidance and best practices to prevent use of AI technologies from exacerbating discrimination in sentencing and other aspects of the criminal justice system.
5. **Protecting the Public.** The EO encourages federal agencies to consider using their existing authorities to enforce existing consumer protection laws and to enact safeguards against fraud, bias, discrimination, and other potential harms from AI, particularly in critical fields like healthcare, financial services, education, and telecommunications.
6. **Protecting Privacy.** The EO emphasizes the importance of protecting privacy and civil liberties as AI technologies continue to develop. In particular, it directs the NIST to develop guidelines related to agencies' use of privacy-enhancing technologies and directs the National Science Foundation to fund the further research and development of privacy-enhancing technologies.
7. **Advancing Federal Government Use of AI.** The EO mandates interagency efforts, led by the Office of Management and Budget, to enhance the federal government's AI capabilities, including by increasing the responsible use of AI technologies by government agencies, where appropriate, and hiring and developing AI talent. Government contractors should expect these initiatives to accelerate agency efforts (such as those of the US Department of Defense as part of its Responsible AI Strategy and Implementation Pathway) to incorporate Responsible AI and ethics principles into contracts with federal agencies.[3]
8. **Strengthening Global Leadership.** The EO aims to bolster American leadership in AI internationally through international collaborations and setting technical standards. It mandates a coordinated effort led by various federal agencies (including the Department of State) to engage with international allies, promote responsible AI practices, and manage AI-associated risks on a global scale.

The EO tasks the secretary of commerce to create a global engagement plan to promote

and develop AI standards—including for AI nomenclature, data handling practices, AI system trustworthiness, and risk management—guided by the National Institute of Standards and Technology's AI Risk Management Framework. The EO also outlines plans for safeguarding critical infrastructure from AI-induced risks and advancing AI in global development, emphasizing a comprehensive approach towards responsible and beneficial AI utilization both domestically and internationally.[4]

## The White House Artificial Intelligence Council

To help implement the directives, the EO establishes the White House Artificial Intelligence Council. Its primary role is to ensure that federal agencies are aligned in developing and implementing policies related to AI, as stipulated by the EO. The AI Council will be chaired by the assistant to the president and deputy chief of staff for Policy.

Its membership will include a broad array of cabinet members and heads of key agencies. The chair is empowered to form and oversee subgroups within the AI Council and to include additional agency heads as necessary to facilitate effective policy coordination and action on AI-related matters.

## Shaping the Regulatory Landscape at Home and Abroad

The EO is the most comprehensive effort to date to outline a federal strategy on AI. It arrives at a pivotal moment for emerging efforts to adopt AI legislation and regulation, reflecting a strategic response to global AI regulatory developments amidst a challenging legislative environment in the United States. With Congressional action unlikely in the near-term and the presidential election coming next year, the EO demonstrates the Biden administration's intent to take initiative, within the confines of executive power, to shape AI policy both domestically and internationally.

With the European Union nearing completion of its comprehensive AI regulatory framework, the AI Act, the EO represents the United States' intent to assert itself as an international leader in AI regulation.[5] This proactive stance may be partly motivated by the United States' experience with the EU's General Data Protection Regulation (GDPR), which had widespread implications for international business practices and set the global benchmark for privacy regulation to the EU's standards.

### Notes

1. *https://www.whitehouse.gov/briefing-room/presidential-actions/2023/10/30/executive-order-on-the-safe-secure-and-trustworthy-development-and-use-of-artificial-intelligence/* and *https://www.whitehouse.gov/briefing-room/statements-releases/2023/10/30/fact-sheet-president-biden-issues-executive-order-on-safe-secure-and-trustworthy-artificial-intelligence/*.
2. *https://www.perkinscoie.com/en/news-insights/white-house-adopts-blueprint-for-an-ai-bill-of-rights.html*.
3. *https://www.whitehouse.gov/wp-content/uploads/2023/03/National-Cybersecurity-Strategy-2023.pdf*.
4. *https://www.nist.gov/itl/ai-risk-management-framework*.
5. *https://www.perkinscoie.com/en/news-insights/the-latest-on-the-eus-proposed-artificial-intelligence-act.html*.

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CYBERSECURITY

# A New Frontier for SEC Cybersecurity Enforcement? The SEC Charges SolarWinds and Its CISO with Securities Fraud

***By Haimavathi V. Marlier, Miriam H. Wugmeister, and David M. Lynn***

In November 2023, the Securities and Exchange Commission (SEC) accused SolarWinds Corporation (SolarWinds or the Company) and its Chief Information Security Officer (CISO) of committing scienter-based[1] securities fraud, among other violations, for allegedly misleading investors about the Company's cybersecurity practices and risks.[2] This lawsuit represents a shift in the SEC's cybersecurity enforcement. The SEC's previous—and rare—cybersecurity enforcement actions largely centered on negligence-based disclosure violations, as well as disclosure and internal controls violations, in the wake of cyber incidents that involved the exfiltration of individual sensitive personal information.

The SEC's Complaint, which includes an unprecedented charge against a CISO, alleges that SolarWinds and the CISO knowingly made false public statements promoting the Company's cybersecurity practices and risks while omitting material information to the contrary. The SolarWinds CEO has called the SEC's suit "misguided and improper . . . representing a regressive set of views and actions inconsistent with the progress the industry needs to make and the government encourages."[3]

**Haimavathi V. Marlier, Miriam H. Wugmeister,** *and* **David M. Lynn** *are partners of Morrison & Foerster LLP.*

## Key Takeaways

- **Cyber Risk Disclosures Matter.** The SEC alleges that hypothetical and generic risk disclosures in periodic SEC filings, even in the *absence* of a material cybersecurity incident, were materially misleading in violation of the securities laws where the company faces known, material risks that remain undisclosed.
- **Form 8-K Disclosures about Material Cyber Events Are under Scrutiny.** SolarWinds disclosed the December 2020 SUNBURST incident in a Form 8-K, but the SEC alleges that the disclosure was materially misleading because it did not disclose that "the vulnerability at issue had been actively exploited against SolarWinds' customers multiple times over at least a six-month period."[4]
- **Charges Against an Individual in Connection with a Cyber Incident.** The SEC alleges that the CISO knowingly made deceptive public statements—including in podcasts and blog posts—that touted the Company's cybersecurity practices and hygiene, despite acknowledging internally and contemporaneously that the Company had serious cybersecurity vulnerabilities. The SEC also claims that the CISO aided and abetted SolarWinds' violations, including related to the Company's allegedly false public statements and in connection with its alleged internal controls failures. In addition to monetary relief, the SEC seeks a permanent officer and director bar against the CISO.
- **First SEC Cyber Enforcement Action to Include Section 13(b)(2)(B) Charges.** The

SEC's application of Section 13(b)(2)(B) of the Securities Exchange Act of 1934—which requires public companies to devise a system of internal accounting controls that prohibit access to a company's assets without management authorization, among other things—stretches the "assets" under the purview of this statute from monetary assets to a company's "information technology network environment, source code, and products."[5] Although the SEC has issued guidance[6] on how Section 13(b)(2)(B) might apply in the cyber enforcement context, this earlier guidance focused on access to an issuer's monetary assets. It remains to be seen if Section 13(b)(2)(B) will accompany other cyber enforcement actions involving alleged internal controls failures.

- **All Public Statements Regarding Cybersecurity Incidents, Practices, and Risks Must Be Carefully Crafted.** The SEC grounded charges for allegedly materially misleading statements made by the CISO and other Company representatives *outside* of the Company's SEC filings, including on SolarWinds' website, in podcasts, and on blogs.
- **Supply Chain Companies Beware.** The SEC's Complaint signals that supply chain companies whose software products are ultimately installed in customers' systems face heightened scrutiny. According to the SEC, "[c]ybersecurity practices are . . . especially important for a company like SolarWinds whose primary product is not only software, but software that other organizations install to manage their own computer networks."[7]

## The SUNBURST Attack

In late 2020, certain SolarWinds customers discovered that Russia-backed hackers had accessed SolarWinds' systems and inserted malicious code into its Orion software platform, which the SEC alleges is the Company's "crown jewel" product.[8] The SEC claims that SolarWinds's delivery of the compromised product to thousands of its customers allowed the threat actors to access certain customers' network environments. This incident became known as the "SUNBURST" attack.

## The SEC's Complaint

The SEC's lawsuit against SolarWinds and its CISO alleges that the Defendants knowingly deceived investors about known cybersecurity risks and vulnerabilities, in addition to having internal controls failures and other violations of the securities laws.

### Fraud Claims

The SEC's allegations against SolarWinds and its CISO go beyond insufficient incident disclosure. Indeed, the bulk of the Complaint's fraud allegations concern what the SEC claims are allegedly deficient risk disclosures that remained hypothetical and generic in the face of known, material risks, as well as false public statements that touted the Company's cybersecurity practices when the actual practices fell short. According to the SEC, "Defendants' false and misleading statements and omissions . . . would have violated the federal securities laws *even if SolarWinds had not experienced a major, targeted cybersecurity attack*."[9]

As to specifics, the Company and the CISO allegedly promoted the strength of SolarWinds' cybersecurity practices in public statements, including in a Security Statement on the Company's website.[10] For example, the SEC alleges that Defendants claimed that SolarWinds followed the widely used and internationally recognized National Institute of Standards and Technology Cybersecurity Framework (NIST Framework) to help identify, prevent, detect, and respond to security incidents. In reality, according to the SEC, SolarWinds met only a small fraction of the NIST Framework cybersecurity controls and had "no program/practice in place" for the majority of the controls.[11]

The SEC also alleges that the Defendants falsely stated that SolarWinds used a secure development

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lifecycle (SDL) when creating software for customers, even though they knew that SolarWinds did not in fact follow an SDL, including for components of Orion that were ultimately accessed by the SUNBURST threat actor. According to the Complaint, the Defendants publicly stated that the Company had implemented a strong password policy while knowing that SolarWinds did not enforce this policy. Finally, the SEC claims that the Defendants falsely stated that SolarWinds maintained strong access controls, when the reality on the ground, according to the SEC, was that "SolarWinds actually had poor access controls," including an expansive use of admin privilege rights and a virtual private network vulnerability.[12]

As for the CISO, the SEC alleges that he knew about SolarWinds' cybersecurity vulnerabilities and deficiencies while simultaneously publicly touting the quality of the Company's cybersecurity practices, including in Company-approved press releases, blog posts, and podcasts. The SEC alleges that the CISO used internal communications, including emails, instant messages, and presentations between the CISO, members of his security team, and Company executives, allegedly demonstrating that the CISO knew that SolarWinds had "pervasive cybersecurity deficiencies."[13]

The SEC further alleges that, in the time leading up to the SUNBURST attack, SolarWinds faced "an accumulating number of red flags" and "multiple successful intrusions against Orion."[14] The risks SolarWinds faced were allegedly documented and discussed internally by the CISO and other Company employees at the time. Upon suffering the SUNBURST attack, Defendants prepared and filed a Form 8-K that allegedly "created a materially misleading picture of the Company's knowledge of the impact of the attack."[15] According to the SEC, the Defendants knowingly failed to disclose that the vulnerability had been exploited on SolarWinds' customers' systems on at least three prior occasions over the prior several months.

### Internal Controls Violations

As is common in SEC cyber cases, the SEC brought charges for internal controls violations. This lawsuit, however, is the first cyber enforcement action that includes a Section 13(b)(2)(B) charge. Specifically, the SEC charged SolarWinds with a failure to employ a system of internal accounting controls that would safeguard its critical assets during a breach. Section 13(b)(2)(B) requires, among other things, that issuers devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that access to company assets is permitted only in accordance with management's general or specific authorization.[16]

Historically, access to company assets comes up where *payments* are made by company employees without proper authorization.[17] The assets at issue in the Complaint, however, appear to be SolarWinds' "information technology network environment, source code, and products," including its "crown jewel," the Orion information technology infrastructure and management platform.[18] The SEC alleges that numerous internal communications in 2019 and 2020 raised doubts about SolarWinds' ability to protect these "critical assets" from cyber threats.

The SEC further alleges that the Company nevertheless failed to remedy vulnerabilities that allowed the SUNBURST threat actor to access and insert malicious code into Orion in violation of Section 13(b)(2)(B). It remains to be seen whether this application of Section 13(b)(2)(B) will stand up in litigation; if it does, this broad definition of "assets" could significantly increase the possibility of similar claims on the heels of cyberattacks involving internal controls failures.

Finally, the SEC alleges that SolarWinds also failed to maintain internal disclosure controls sufficient to ensure that information regarding potentially material cybersecurity risks, incidents, and vulnerabilities was escalated to the executives responsible for disclosures, in violation of the Exchange Act Rule 13a-15(a). As a result, cybersecurity issues that had the potential to materially impact SolarWinds allegedly went unreported.

## Notes

1. In other words, the SEC has charged SolarWinds and its CISO with intentionally and knowingly committing securities fraud.
2. *Complaint,* SEC v. SolarWinds Corp. and Timothy G. Brown, No. 23-cv-9518 (S.D.N.Y. Oct. 30, 2023), (hereinafter, the Complaint or SolarWinds Compl.).
3. Ramakrisha, Sudhakar, "Transparency, Information-Sharing, and Collaboration Make the Software Industry More Secure. We Must Not Risk Our Progress" (Oct. 30, 2023).
4. SolarWinds Compl. ¶ 17.
5. *Id.* ¶ 195.
6. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements*, SEC Release No. 84429 (Oct. 16, 2018).
7. SolarWinds Compl. ¶ 54.
8. *See id.* ¶ 2.
9. *Id.* ¶ 10 (emphasis added).
10. Although CISOs are not typically responsible for statements made on company websites, the SEC claims that, in this case, the CISO was "was primarily responsible for creating and approving the Security Statement before it was posted," and that he "disseminated the Security Statement, or a link to the Security Statement, to customers seeking more information about SolarWinds' security practices." *Id.* ¶ 39.
11. *Id.* ¶ 49.
12. *Id.* ¶ 91.
13. *Id.* at 36.
14. *Id.* ¶ 137.
15. *Id.* ¶ 185.
16. 15 U.S.C. § 78m(b)(2)(B).
17. In an October 16, 2018, Section 21(a) Report of Investigation, the SEC discussed the possibility that Section 13(b)(2)(B) could apply to victims of cyberattacks, but the SEC has never brought any enforcement action under that theory. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements*, SEC Release No. 84429 (Oct. 16, 2018)
18. SolarWinds Compl. ¶ 195.

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BOARD DUTIES

# Blue Bell Meltdown Serves Up a Double Dip of Danger for Directors

***By James A. Deeken***

A recent combination of two interesting cases arising from the same underlying fact pattern—*Marchand v. Barnhill*[1] and *Discover Property & Casualty Insurance et al v. Blue Bell Creameries USA, Inc.*[2]—highlight the need for corporate directors to understand not only their duties but the scope of insurance coverage that applies, or in some cases does not apply, to those duties.

Perhaps there is no greater nightmare for a corporate director than to be held liable for a duty they didn't know about in a situation where neither indemnification nor insurance applies. The situation may seem unreal to some, but recent case law underscores that liability nightmares for directors are not isolated to dreams.

Bell Blue Creameries USA, Inc., one of the most established and longest serving, manufacturers and distributors of ice cream, had an outbreak of listeria in 2015 at its facilities that resulted in three deaths and led to a large-scale recall of Blue Bell products. The situation resulted in an alleged decrease in value for pre-existing stockholders. A stockholder brought a derivative claim on behalf of the company against its directors and certain of its officers seeking recourse for the liabilities incurred by the company as a result of the listeria crisis.[3]

The concept that a director can be personally liable for a mishap at a corporation for which they serve as a director may seem to contravene the understanding of corporate law that most directors have and operate under in the performance of their services. Most director liability is thought of in the context of the "business judgment rule," a long-standing principle of corporate law that generally provides a court will not second guess a properly informed business decision made by a director in good faith absent certain excepted circumstances described below.

While directors generally take comfort from the business judgment rule, less commonly understood is that the business judgment only applies to the exercise of a director's duty of care and not the exercise of a director's duty of loyalty or a director's duty to act in good faith. Perhaps even less commonly understood are the pitfalls that accompany the duty of loyalty and duty to act in good faith.

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## Basic Director Delaware Law Duties[4]

The following is a brief overview of some of the elements of Delaware fiduciary law as applied to members of a Delaware corporation's board of directors to help frame the issues presented by the Blue Bell scenario. An exhaustive and complete analysis of such duties would merit a separate law review article in and of itself. Under Delaware law, directors owe fiduciary duties to the corporation and its shareholders.[5] A director's fiduciary duties include both a duty of care and a duty of loyalty,[6] with an overall obligation to act in good faith.

The duty of care requires a director to be informed about the affairs of the corporation and all material information reasonably available before making a business decision.[7] Directors must then act with requisite care[8] and use the care that ordinarily careful and prudent people would use in similar circumstances after considering all information reasonable

available.[9] Under the duty of care, directors in some cases rely on reports and information provided by the corporation's officers, legal counsel, public accountants, investment bankers, and other individuals on matters pertaining to the corporation.

Directors' decisions pursuant to the duty of care generally are subject to the business judgment rule. Under the business judgment rule, a court generally will give deference to the board and will not substitute its own judgment for that of the board, even if a decision turned out to be unwise, so long as the directors acted on an informed basis, in good faith, and in the rational belief that the decision made was in the best interests of the corporation and its stockholders.[10] Delaware law presumes that "in making a business the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interests of the company."[11]

Those presumptions can be rebutted if a plaintiff shows that the directors breached their fiduciary duty of care (by acting with gross negligence) or of loyalty or acted in bad faith,[12] otherwise acted in an uninformed manner,[13] or abdicated its functions,[14] or failed to act[15] or were not disinterested.[16]

The duty of loyalty requires directors to refrain from self-dealing and to act in good faith.[17] A director's own financial or other self-interest may not take precedence over the interests of the corporation and its stockholders when making decisions on behalf of the corporation.[18] The director must also refrain from any conduct that would injure the corporation and its stockholders or deprive the corporation of profit or advantage.[19]

Closely related to the duty of loyalty, is the duty of a corporate director to act in good faith.[20] The duty to act in good faith requires that a director avoid "subjective bad faith," conduct motivated by an actual intent to harm to the corporation.[21] However, a director can also breach its obligation to act in good by consciously disregarding a duty at act.[22] In the words of one Delaware Chancery Court opinion:

> The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.[23]

## Why Good Faith Poses Accented Personal Liability Risks for Directors

The absence of the business judgment in the context of the duty of loyalty may be enough of a danger for a director. However, the absence of a potential indemnity for a claim involving the breach of loyalty combined, with the absence of the business judgment rule has a real potential for a director to be bare of traditional liability protections.

Section 145(b) of the Delaware General Corporation Law provides that a corporation has the power to indemnity a person who is party to an action brought in the name of the corporation "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation." The restriction makes it difficult for a director to prevail for indemnity when they are adjudicated to be liable for a breach of the duty of loyalty, as a breach of the duty of loyalty is usually determined to arise from a director acting in bad faith or in manner they did not reasonably believe to be in the best interest of the corporation.[24]

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## *Caremark* and the Delaware Duty of Loyalty/Good Faith Liability Trap

Breaching the duty of loyalty or obligation to act in good faith may sound like something that would require some intentional conscious wrongdoing doing on the part of a director. *In re Caremark Int'l Inc. Derivative Litig.*[25] arguably tells a different story. In *Caremark*, the Chancery Court determined that directors can be deemed to have acted in breach of their duty of loyalty if they did not in good faith make efforts to implement a monitoring and reporting system for a corporation.

The *Caremark* standard was elaborated on by the Delaware Supreme Court in *Stone v. Ritter*,[26] as explained by the court:

> We hold that Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[27]

What is interesting is that *Caremark*, as amplified by *Stone*, the Delaware Supreme Court seems to be combining the duty of loyalty with the duty of a director to act in good faith.

## Blue Bell's First Dip

In *Marchand*, the Delaware Supreme Court noted the Court of Chancery originally had dismissed plaintiff's claims on the grounds, that among other things, that it viewed the plaintiff complaint as having alleged not the absence of monitoring and reporting controls but instead challenging the effectiveness of monitoring and reporting controls. The court disagreed and stated that the complaint had plead particularized facts to support a reasonable inference that the board had failed to implement any system to monitor the company's food safety performance or compliance.

In the reasoning of the court, directors have a duty to exercise oversight and to monitor a corporation's operational viability, legal compliance and financial performance and a board's utter failure to attempt to assure a reasonable information and reporting system exists constitutes an act of bad faith in breach of the duty of loyalty. Along these lines, the court explained that the complaint alleged facts, among other things, that there was no board level effort at monitoring and thus supported an inference that the directors consciously failed to attempt to assure that a reasonable information and reporting system existed.

The court went to lengths to point out that board minutes reflected no discussion of health and safety issues at the company had arisen on inspections in the years prior to the listeria outbreak and that the matter was not discussed until the outbreak. The court also noted that the pleadings alleged that there was no board committee charged with monitoring food safety, no portion of the board meetings were devoted to food safety compliance and the lack of a protocol for management delivering compliance reports or summaries to the board on a consistent and mandatory basis.

The court noted that the rationale for the Chancery Court's dismissal was the existence of sanitation manuals and procedures with board reporting on the company's operations. In analyzing the Chancery Court's dismissal, the Court noted that directors must not only make a good faith effort to implement an oversight system but to monitor it as well.

Although the court noted that defendants claimed that the company had in place systems to comply with applicable safety laws, the Court emphasized

that these were not board level reporting items. The court was also not convinced with an argument that the Board was briefed on operational issues at the company level. The court instead highlighted that there was alleged to be no monitoring with respect to food health and safety specifically.[28]

## The Contours of *Marchand*

*Marchand* does not arguably change or modify *Caremark* but at the very least it accents how a board needs to make sure that it has procedures for monitoring areas that pose risks for a corporation. *Marchand* and *Caremark* when read together leave several unanswered questions that directors may find discomforting.

For example, assume there is a corporation that engages in the provision of healthcare services and one of the greatest risks is assumed quite rationally to be the quality of healthcare that it provides. So, if the board puts in place some system for monitoring risks related to that. Are they home free under *Caremark*?

Assume a year later the corporation has a cyber security issue and personal information of patients is compromised resulting in patient litigation against the corporation. Assume the board had no mechanism in place for monitoring cyber security risks. Are the directors liable under *Caremark*? Could they argue that cyber security was not thought to be one of the main risks?

The potential issue for directors is what constitutes a material risk for a corporation is sometimes judged in retrospect with hindsight bias. Should a nervous director try to think of every conceivable risk and demand system for monitoring it? Would that even be good enough to ward off any risk of *Caremark* dangers? Will there always be some risk that somebody did not think of?

Is it sufficient to have a monitoring system for the main risk or does *Caremark* require monitoring systems for multiple risks. The Chancery Court in *Marchand*[29] seemed to focus on the fact that there was a general system in place for monitoring operational aspects. The Delaware Supreme Court however went to great lengths to point out that even though there was a system for monitoring operational aspects there was not a system in place for monitoring food safety which was the main risk to the company.[30] Does the board monitoring duty stop at the main risk, or does it continue on to other material risks? Also, unanswered is a situation in which there may be disagreement about the main risks faced by a company. For *Marchand* it seemed easy, at least in the opinion of the Court, to identify the main risk. Other corporations may have a more muddled picture of the main risk that they face.

The landscape that corporations operate under is one of increasing regulation and liability, not one of lessening regulation and liability. That, coupled with an enhanced focus on Environmental, Social, and Governance (ESG), increases both the volume and magnitude of risks that any given corporation could face. Under *Caremark/Marchand* are directors being de facto supervisory compliance officers?

Another important import of *Marchand* is that even if there is a system in place to monitor a danger that alone will not be sufficient to ward off liability. Even if in *Marchand* had the plaintiff not alleged the lack of a monitoring system for food health and safety issues, it is not clear that the defendants would have prevailed on summary judgment. Even if there is a monitoring system in place, plaintiffs are free to allege that the system although implemented was not properly monitored by a board.

Thus, even if a board can think of every risk that might later be alleged to be material and put in and implemented a system for monitoring risks, the board would still conceivably be at risk for a claim that it did not actively monitor the reporting. Again, the risk of hind sight bias could create a fair amount of second guessing on the point. So, if a board did have a cyber security risk monitoring system in place and monitored it every quarter, could a plaintiff allege in hindsight if an issue arises that it should have been monitored every month? Some of the dicta in *Marchand* about the discretion the board has along these lines might suggest not, but the result is less than clear.

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Would anyone ever allege a breach of *Caremark* duties? Unfortunately, yes. If a plaintiff alleges misconduct on the part of a board, it does them perhaps very little good if indemnification, the business judgment rule, and exclusion from liabilities under the corporation's certificate of incorporation apply. Thus, even though the pleading standards are harder, plaintiffs in some cases have more of an incentive to file breach of duty of loyalty claims than breach of care claims.

For a director what is particularly alarming about the *Caremark/Marchand* line of cases is that they arguably obscure the dividing line between the duty of care and the duty of loyalty. In *Marchand* for example, there was no allegation that the directors received some sort of improper personal benefit or were subject to a conflict of interest transaction. The lack of those allegations is significant.

It might be tempting to argue, from a policy standpoint, that absent any sort of improper benefit or interested director transaction, a board should be able to determine in its business judgment what types of monitoring systems, if any, for certain dangers are appropriate. However, *Caremark* and *Marchand* could be viewed as importing over an element of the duty of care, where the business judgment rule generally applies and where indemnification may be available, to the duty of loyalty where the business judgment rule is absent and where corporate indemnification is not generally available. The result is a potential gaping hole in personal liability protection for directors even in situations where there was not an improper personal benefit or conflicted interest.

At this point, assume a director throws up his hands and says "Fine. I will rely upon insurance." There are a number of issues with insurance often cause it not to be a rain proof umbrella. Those can, among other things, include the nature of claims made policies, limits, conditions, deductibles and exclusions that are beyond the scope of this particular article. However, the Blue Bell litigation highlights the importance of not just having insurance but of having the right type of insurance for the right type of liability.

## Blue Bell's Second Dip

In *Discover*, a federal district court and the US Fifth Circuit Court of Appeals addressed a dispute between Bell Blue and defendants in the *Marchand* litigation on one hand and insurers on the other hand.

The court began with a history of the facts giving rise to the Marchand litigation and a summary of the claims thereunder, noting in particular that the claims alleged a breach of the duty of loyalty for willfully failing to manage the company and institute a system of controls and reporting. The court noted that during the periods in question that Blue Bell and related entities were covered by several commercial general liability, or CGL, insurance policies issued at various times by the applicable insurance companies. These policies covered not only the Blue Bell entities but also officers and directors "with respect to their duties" as officers and directors of the Blue Bell entities. Specifically, the policies covered occurrences (generally defined as accidents) resulting in bodily injury or property damage.

The Blue Bell entities gave notice of claims to the insurers related to the Marchand litigation, which prompted the insurers to file suit contesting coverage.

The court explained that at least under Texas law the duty of insurer to defend and provide an indemnity is covered exclusively by the complaint itself and policy, that is, if the complaint does not allege a claim that is covered by the policy, then there will be no duty to defend and provide indemnity.

The insurers argued that because the defendants were alleged to breached their fiduciary duties, that they were not acting "with respect to" those duties and thus are not insureds under the applicable policies. The district court, relying in part on US Eight Circuit Court of Appeals precedent and US Ninth Circuit Court of Appeals precedent reasoned that a GCL policy, such as the one at issue, would only cover officer and directors when they acted in accordance with their duties and not in breach of duties owed by them to the insured entity.[31]

The court also went to great length to put out that the cases cited by the defendants were ones that addressed directors' and officers' liability policies that were designed to cover individuals such as the officers and directors in the present case and not GCL policies like the one at issue. It is interesting to note that the court arguable read "with respect to duties" to mean "in accordance with duties," which may have not synced with the way someone might have read and understood the policy as applying, absent guidance of the case law cited by the court.

The Fifth Circuit disagreed and determined that the directors and officers were acting with respect to their duties since the actions taken by them were not alleged to be outside of the scope of managing the applicable business.

The Fifth Circuit however reasoned that coverage was not applicable for independent reasons. The policy covered "accidents" and the court viewed matters arising from a breach of fiduciary duty as not accidental in nature. The court further pointed out that the defendants' insurance claims related to financial matters instead of ones related to bodily injury within the meaning of the policies.

The most important take away for directors is not merely to ask whether a company has insurance covering directors when agreeing to serve on a corporate board but whether the company effectively has the right type of insurance. In this case, the reliance on a CGL policy may have been mis-placed but a director and officer liability policy, depending on its specific wording, might have provided the desired coverage. One note of caution though is that director and officer liability policies can often contain exceptions from coverage for breaches of the duty of loyalty or bad faith, which could create a hole in insurance coverage for *Caremark* liabilities.

Secondly, the case serves as a reminder that coverage under policies ties to the exact wording of those policies, and at times, the wording may be applied by a court in a manner that is not necessarily intuitive. The lingering question then is whether a director should not only ask what type of insurance is provided but perhaps ask whether the board has had an insurance coverage lawyer review the applicable policy or policies.

Finally, Blue Bell was a private company as opposed to a publicly traded company. The case serves as an additional reminder that director and officer liability exist not just in the context of public companies but in the context of private companies as well.

## Notes

1. Marchand v. Barnhill, 212 A.3d 805 (Del. 2019).
2. Discover Property & Casualty Insurance et al v. Blue Bell Creameries USA, Inc., 73 F.4th 332 (5th Cir. 2023).
3. *Marchand*, 212 A.3d at 807.
4. The summaries of law contained herein are for educational and informational purposes, they do not contain the legal detail necessary for legal advice, and are not tailored for the specific relevant facts of any situation, and thus, should not be construed as legal advice.
5. McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).
6. *McMullin*, 765 A.2d at 917.
7. *Smith*, 488 A.2d at 872; In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005) (noting that the business judgment rule does not apply if directors make an "unintelligent or unadvised judgment"), *aff'd* 906 A.2d 27 (Del. 2006); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); McMullin at 922 (noting that the business judgement rule can be rebutted if directors failed to exercise due care in informing themselves prior to making a decision).
8. *Aronson*, 473 A.2d at 812.
9. *Walt Disney*, 907 A.2d at 749; *Aronson*, 473 A.2d at 812 (noting that once being informed, directors must act with requisite care).
10. *Smith*, 488 A.2d at 873 (*citing* Aronson at 812); *Walt Disney*, 906 A.2d at 52 (requiring an informed basis, good faith and honest belief that the action was in the bests interests of the relevant corporation).
11. *Aronson*, 473 A.2d at 812.
12. *Walt Disney*, 907 A.2d at 747; *Smith*, 488 A.2d at 872 (We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.)

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13. *Smith*, 488 A.2d at 872.
14. *Aronson*, 473A.2d at 813.
15. *Id*.
16. *McMullin*, 765 A2d. at 923.
17. *Walt Disney*, 907 A.2d at 751.
18. *Id*. at 751.
19. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987).
20. In re Caremark Int'l Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996); Nagy v. Bistricer, 770 A.2d 43, 48, n. 2 (Del. Ch. 2000).
21. *Walt Disney*, 907 A.2d at 752.
22. *Id.* at 755.
23. *Id*. The Delaware Supreme Court explained that there are three categories of bad faith: (i) subjective bad faith when motivated with an actual intent to do harm; (ii) conduct resulting from gross negligence without malevolent intent; and (iii) intentional dereliction of duty, a conscious disregard of one's responsibilities. *Walt Disney*, 906 A.2d at 26-30.
24. Likewise, Section 102(b)(7) of the Delaware General Corporation law allows a corporation to exculpate directors from monetary damages for a breach of the duty of care, but not for acts or omissions not in good faith. *See also Disney*, 906 A.2d at 28-29.
25. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).
26. Stone v. Ritter, 911 A.2d 362 (Del. 2006).
27. *Stone*, 911 A.2d at 370.
28. *Marchand* seems to be in line with a number of recent Delaware court cases that have been determined favorably for plaintiffs. *See* In re Boeing Co. Derivative Litig., 2021 WL 4059934 (Del. Ch. 2021); In Re Clovis Oncology, Inc. Derivative Litigation, 2019 WL 4850188 (Del. Ch. 2019); Hughes v. Hu, 2020 WL 1987029 (Del. Ch. 2020); Teamsters Local 443 Health Services & Insurance Plan v. Chou, 2020 WL 5028065 (Del. Ch. 2020). *Compare* Firemen's Retirement System of St. Louis v. Sorenson (Marriott), 2021 WL 4953777 (Del. Ch. 2021) and In City of Detroit Police and Fire Retirement System *ex rel* NiSource Inc. v. Hamrock dismissing *Caremark* claims.
29. *Marchand*, 2018 WL 4657159 (Del. Ch. 2018).
30. "the obviously most central consumer safety and legal compliance issue facing the company…" *Marchand*, 212 A.3d at 805.
31. Discover Property & Casualty Insurance et al v. Blue Bell Creameries USA, Inc. et al, 622 F.3d. Supp. 349 (W.D. Tex. 2022).

## FORUM SELECTION

# The Delaware Court of Chancery and the California Jury Trial Right

***By John D. Hendershot and Gidon M. Caine***

Civil litigation practitioners in Delaware quickly learn these few rules of thumb. Delaware, unlike the federal court system and most other state court systems, retains distinct courts of law and equity. The Delaware Superior Court is the law court and the trial court of general subject-matter jurisdiction. The Delaware Court of Chancery is the equity court, possessing limited subject-matter jurisdiction based on the jurisdiction of the English Court of Chancery at the time of American independence. The Superior Court cannot award uniquely equitable relief, such as injunctions, but can award punitive damages (which the Court of Chancery cannot). And consistent with historical practice, trial by jury is available in the Superior Court, but not in the Court of Chancery.

The continuing separation of Delaware's law and equity courts largely avoids a set of problems with which merged court systems historically have struggled. When a case features both legal claims, for which a (state or federal) constitutional jury trial right exists, and equitable claims or requests for equitable remedies, for which no such right exists, what should the jury be asked to decide, and at what stage of the case?[1] The federal courts and state courts have adopted various approaches to those questions over time, but for the most part in Chancery practice, the answer is simple: once the Court's subject-matter jurisdiction is properly invoked, the equitable clean-up doctrine allows the Court to adjudicate via a bench trial all claims in the case. There is no state constitutional right to a jury trial in the Court of Chancery.[2]

The absence of jury trials in normal practice in the Court of Chancery creates a conundrum for the California practitioner seeking means to channel a client's potential disputes for resolution in Delaware. Delaware business entity statutes expressly authorize entities to include provisions in their governing documents requiring that certain categories of disputes be brought exclusively in Delaware courts.[3] Contracting parties also frequently agree that future disputes over the subject matter of their agreements will be brought exclusively in a particular court or set of courts. California courts are willing in principle to enforce such a choice-of-forum clause, and to dismiss an action brought in California in violation of the clause, as long as enforcement of the clause is not unfair, unreasonable, or contrary to public policy.

But California as a matter of its own strong public policy *does not* enforce advance contractual waivers of the right to trial by jury in a civil case. The rationale for this rule is that the California constitution protects the right to trial by jury in civil cases unless "waived by the consent of the parties expressed as prescribed by statute."[4] The relevant California statute, Section 631 of the Code of Civil Procedure, does not permit parties to waive trial by jury in advance by contract.[5] Thus, under the California Supreme Court's 2005 decision in *Grafton Partners v. Superior Court*, contractual waivers of the right to a civil jury trial are invalid and unenforceable in the California courts.[6]

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## California Right to Jury Trial

The California Court of Appeal has applied the *Grafton Partners* rule to decline to enforce forum-selection clauses when doing so would deprive a litigant of the right to jury trial, at least on the facts presented in two recent decisions.

In *Handoush v. Lease Finance Group, LLC*,[7] the parties to a contract agreed to litigate any disputes in the New York state courts, and also agreed to waive jury trial, a provision that ordinarily would be enforceable in the New York courts. The California trial court granted a *forum non conveniens* dismissal motion, but the First District Court of Appeal reversed. The Court of Appeal determined that the party seeking dismissal bore, and had failed to carry, the burden of demonstrating that dismissal would not infringe on the opposing party's constitutionally protected right to a jury trial.[8] The California Supreme Court initially granted review, but subsequently dismissed and remanded, denying an untimely request for depublication of the opinion of the Court of Appeal.

Four years later, in *EpicentRx, Inc. v. Superior Court*,[9] the Fourth District Court of Appeal reviewed a trial court decision that declined to enforce against a stockholder-plaintiff a mandatory forum-selection provision in the certificate of incorporation of EpicentRx, a Delaware corporation. That provision, expressly authorized under 8 *Del. C.* § 115, required internal corporate claims to be brought exclusively in the Delaware Court of Chancery.

A minority stockholder sued EpicentRx and several of its officers, employees, and affiliates in San Diego County Superior Court, claiming breaches of fiduciary duty, violations of California Business and Professions Code Section 17200 *et seq.*, fraudulent concealment, promissory fraud, and breach of contract. The stockholder demanded a jury trial on all claims to which the right of a jury trial attached. EpicentRx and several other defendants moved to dismiss based on its forum-selection provision.

The California Superior Court declined to enforce the forum-selection provision and denied the motion to dismiss, reasoning that under California law, the stockholder-plaintiff was entitled to a jury trial on its fraud claims (though not on other claims, including the fiduciary duty claims), and that under *Grafton Partners*, this was a fundamental right that could not be waived through a predispute agreement, including a certificate of incorporation or bylaw provision.

According to the Superior Court, EpicentRx's forum-selection provision was a *de facto* pre-dispute jury trial waiver because it required the parties to litigate in the Delaware Court of Chancery, which does not guarantee a right to a jury trial. Thus, the trial court reasoned, under the burden-shifting analysis applied in *Handoush* and the precedents on which that decision relied, the moving defendants were obliged to show that enforcement of the forum-selection provision would not diminish the stockholder-plaintiff's rights under California law. The trial court found that the defendants had failed to carry this burden because the stockholder-plaintiff would lose its right to trial by jury if required to proceed in the Court of Chancery.

The defendants petitioned the Court of Appeal for a writ of mandate. The Court of Appeal did not question the facial validity of the forum-selection provision or the application of Delaware law to the corporation's internal affairs.[10] However, applying the burden-shifting framework, the Court of Appeal agreed that the moving defendants were required to show that "litigating the claims in the contractually designated forum will not diminish in any way the substantive rights afforded ... under California law."[11]

The Court of Appeal emphasized that "there is no dispute that [the stockholder-plaintiff] would be entitled to a jury trial in California for at least some of its claims—specifically, its fraudulent concealment, promissory fraud, and breach of contract causes of action."[12] But the same claims would not be subject to jury trial in the Delaware Court of Chancery.[13] Thus, the Court of Appeal stated, "all parties agree [that] the forum selection clauses in EpicentRx's corporate documents, as a practical matter, operate as implied predispute waivers that will

deprive [the stockholder-plaintiff] of its right to a jury trial."[14]

The Court of Appeal rejected on practical grounds the moving defendants' argument that the claims that would *not* be subject to trial by jury in California—including the breach of fiduciary duty claims—should be dismissed in California without prejudice to a refiling in the Court of Chancery. The Court of Appeal found no error in the Superior Court's determination that "a partial dismissal of claims would create inefficiencies by requiring the parties to litigate their dispute in multiple fora on opposite ends of the country and, furthermore, it would create a risk of inconsistent findings rendered by different courts."[15]

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## Choice-of-Forum Clauses

On the surface, rulings of this nature might suggest that choice-of-forum clauses in favor of the Court of Chancery, including both those agreed to among contracting parties and those placed in a Delaware corporation's governing documents under the authorization granted in Section 115, may be difficult or impossible to enforce against litigants—whether contract counter-parties, stockholders, or otherwise—who might prefer to sue in California rather than Delaware. California litigants with that preference may thus argue that California's constitutional protection for the right to jury trial in civil cases gives them a non-waivable right to sue in California, no matter what they may previously have agreed, and no matter what a Delaware corporation's constitutive documents may provide.

One important response to such a position is that nothing in *EpicentRx* or its predecessor jurisprudence should have any effect on parties' ability to channel disputes to Delaware's Superior Court, where jury trials are available. The Delaware Superior Court has a well-regarded Complex Commercial Litigation Division, which regularly hears and decides sophisticated business disputes. The Delaware statutes authorizing exclusive forum provisions in entity organizational documents allow such provisions to select the courts in the State of Delaware, not only the Court of Chancery, as the exclusive forum for resolving internal affairs claims.[16] A Delaware statute authorizes cases to be transferred from a state court that lacks subject-matter jurisdiction to the state court that possesses it.[17] To the extent separate law and equity proceedings are necessary, coordination between judges of peer courts within the same small state poses less risk of inconsistent results than proceedings in different states.

A less-remarked but potentially more significant response is that Delaware's constitution authorizes special designation, a process through which a judge of one state court may sit temporarily as a judge of another. A judge of the Court of Chancery thus has the ability to seek designation to sit as a Superior Court judge for the purposes of conducting a jury trial on part or all of a dispute, and a Superior Court judge may seek designation to hear matters in equity. Special designation is a discretionary process, not a matter of state constitutional right. Nevertheless, it is technically incorrect to assert that litigation in the Court of Chancery can never include a jury trial.

Special designation is authorized by Article IV, Section 13(2) of the Delaware Constitution, which permits the Chief Justice of the Delaware Supreme Court to designate a state court judge to sit temporarily as a member of one of the state trial courts, including both the Court of Chancery and the Superior Court.[18] Historically, this process often has been used to allow a jurist who is moved from one state court to another to continue to preside over specific outstanding matters on the court of origin, where that course is deemed more efficient than handing those matters over immediately to the successor jurist on that court.[19]

However, special designation has gained greater prominence in recent years, in part due to the growing caseload of the Court of Chancery and the growing prominence of the Complex Commercial Litigation Division of the Superior Court. On the Chancery side, much of the increased caseload is attributable to statutory expansions of the Court's subject-matter jurisdiction. The Court of Chancery's

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traditional jurisdiction extends to "all matters and causes in equity,"[20] but not to "any matter wherein sufficient remedy may be had by common law, or statute, before any other court or jurisdiction of this State."[21]

Beginning in the 1990s, the Delaware General Assembly further expanded the statutory jurisdiction of the Court of Chancery on a non-exclusive basis to encompass a wide variety of claims as among business entities and their owners and managers, even if there are no equitable claims or requests for equitable remedies.[22] This has led to a growing caseload of what are in essence breach of contract suits for damages—classically "common law" rather than "equitable" claims—over which the Court of Chancery has subject-matter jurisdiction by virtue of a statutory grant, rather than as part of its equitable jurisdiction.

The Superior Court has shared in that growing caseload, due in part to the creation in 2010 of the Complex Commercial Litigation Division (CCLD), which is designed to provide streamlined treatment to qualifying matters.

The two courts have responded in part by using special designation to allow Superior Court judges, frequently members of the CCLD panel, to sit as Vice Chancellors to preside over matters that fall within the Court of Chancery's expanded "statutory" jurisdiction but are in substance similar to the contract disputes and other business disputes that form the bulk of the CCLD's docket.

Special designation for this purpose occurred on an *ad hoc* basis until February 2023, when the Delaware Supreme Court entered an order, explicitly for a trial period of one year, designating the five current CCLD panel judges "to sit as a Vice Chancellor on the Court of Chancery for the purpose of hearing and deciding cases filed under Section 111 [of the Delaware General Corporation Law] as selected by the Chancellor and the President Judge." That is, the Supreme Court authorized the presiding judicial officers of the Court of Chancery and the Superior Court to assign the CCLD judges to sit as Vice Chancellors on a broad category of matters within the Court of Chancery's expanded jurisdiction, rather than requiring the involvement of the Chief Justice in each case.

The following month, the Court of Chancery published "Guidelines for Requesting Special Designation of Judicial Officers in Court of Chancery Actions."[23] This document emphasizes that the process for special designation "should be invoked sparingly and only in those cases where special designation would (1) promote judicial economy; (2) avoid the risk of inconsistent decisions among various courts; or (3) otherwise further the interest of justice."

The Guidelines further identify common considerations in dealing with such applications, including whether the case was properly filed in the appropriate court in the first instance, whether there are multiple actions at law and equity pending simultaneously but there are practical reasons for a single jurist to preside over both, whether an outright transfer to a court with appropriate subject-matter jurisdiction is opposed, and whether special designation would address or mitigate a conflict of interest on the part of the judicial officers.

The Guidelines make clear that the process is discretionary. The trial judge is responsible for requesting special designation in the first instance, and the concurrence of both the Chancellor and the President Judge of the Superior Court is also required. Absent the unanimous agreement of all three jurists, special designation ordinarily will not occur.

The Guidelines do not specifically address the situation akin to *EpicentRx*, that is, a matter in which a forum-selection provision in favor of Chancery exists, but the non-availability of jury trial in normal Chancery practice constitutes an obstacle to enforcement of the forum-selection provision in the courts of another state. However, the Delaware constitutional authorization for cross-designation is limited only by the discretion of the Delaware judiciary. Under Delaware law, a single member of either of the two trial courts can be designated to preside both in law and in equity over a dispute.

The authors are not aware of any Delaware precedent on facts comparable to those in *EpicentRx*,

where special designation was sought or employed to vindicate simultaneously a forum-selection provision and another state's civil jury trial guarantee. However, two recent precedents may indicate a willingness on the part of the Delaware judiciary to employ special designation in such a circumstance.

## *BDO USA, LLP v. EverGlade Global, Inc.*: Special Designation for Defamation Claims

The Court of Chancery has employed the special designation process to enable a defamation claim, originally brought in Chancery, to be heard as a Superior Court case with the Chancellor presiding. The matter involved a partner of BDO USA, Eric Jia-Sobota, who formed a rival consulting firm, EverGlade Global, Inc., while still at BDO. BDO and Jia-Sobota were parties to litigation over the latter's actions in the District of Columbia in 2020 and 2021. However, in early 2021, BDO was the target of a "social media smear campaign," for which it attributed responsibility to EverGlade. In March 2021, BDO sued EverGlade in the Court of Chancery for defamation and tortious interference with business relations, seeking an injunction requiring removal of the allegedly defamatory posts, as well as damages.

Following discovery proceedings, BDO moved for sanctions for alleged spoliation of evidence by EverGlade. The Court of Chancery scheduled a hearing on that motion for March 2022. Days before the hearing, EverGlade moved to dismiss the Chancery proceeding for lack of subject-matter jurisdiction, arguing that "because the conduct at issue in BDO's claims is speech, a jury should be available to decide the central issues, such as malice and damages for the defamation claim."

The Chancellor wrote, "Upon review, I determined that Court of Chancery jurisdiction would be proper over the majority of BDO's claims, but was concerned about overextending equitable authority when it pertains to speech. Nonetheless, transferring the case either in its entirety or in part to a separate jurist would have resulted in judicial inefficiency, given the resources invested into this case to date. Furthermore, it might have rewarded EverGlade for attempting to wriggle out of accountability for its sanctionable conduct."[24]

The Chancellor accordingly requested and obtained special designation to sit as a Superior Court judge. The case was transferred to the Superior Court docket and EverGlade filed a jury trial demand. In January 2023, the Court entered default judgment against EverGlade as a sanction for spoliation. In August 2023, the Chancellor, still in her capacity as a specially designated Superior Court judge, granted BDO's motion for leave to amend its pleading to seek punitive damages, stating that if BDO did so, the Court would convene a jury to assess damages, but that if BDO elected not to do so, the Court would resolve BDO's damages claim through a bench trial.[25]

Undoubtedly, *BDO USA v. EverGlade* involved an extreme set of facts. Default judgment as a sanction for discovery misconduct is rare in Delaware. Successful motions to dismiss for lack of subject-matter jurisdiction tend not to be made many months into a case and on the eve of a hearing on a motion for sanctions for alleged discovery misconduct.

The case also implicates another important constitutional value, freedom of speech. Anglo-American equity courts for centuries have been reluctant to impose injunctive prior restraints on speech, even if the speech is allegedly defamatory or otherwise allegedly wrongful. Defamation cases in the Delaware state court system ordinarily are brought in the Superior Court. A recent Chancery decision holds that a request for injunctive relief against future defamatory speech was not sufficient to invoke the equity jurisdiction of the Court.[26]

However, that decision also raises expressly the possibility that a plaintiff who pursues a successful defamation claim in the Delaware Superior Court may seek either transfer to the Court of Chancery at the remedial stage, to consider potential injunctive relief, or cross-designation of the Superior

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Court judge to sit as a Vice Chancellor for the same purpose.[27]

## *West v. Access Control Related Enterprises, LLC*: Discussion of Special Designation to Protect the California Jury Trial Right in an LLC Case

Another recent case in the Delaware Superior Court, *West v. Access Control Related Enterprises, LLC*, gives some cause for optimism that the Delaware courts may be willing to use special designation to enable contract counterparties or business entities to vindicate their choices of forum while also providing the parties with access to a jury trial, where a right to jury trial does not exist under Delaware law but does exist under the laws of California or another state.

*West* concerned the removal for cause of the plaintiff, William West, as CEO and COO of the defendant, Access Control Related Enterprises, LLC (ACRE), a Delaware limited liability company. In 2016, West sued ACRE's majority owners in the California Superior Court. In May 2017, the California Superior Court stayed the case in reliance on forum-selection provisions, and West refiled in the Delaware Superior Court's Complex Commercial Litigation Division. In June 2018, the Delaware Superior Court granted a defense motion to transfer the case to the Court of Chancery, based on the latter court's equitable jurisdiction over West's claims for breach of fiduciary duty.

Instead of taking the procedural steps necessary to effectuate the transfer, West sought leave to amend his complaint to drop the fiduciary duty claim. The Delaware Superior Court granted this motion. Following Rule 12 practice, in 2019 the defendants again asked the Delaware Superior Court to allow the transfer of the surviving claims to the Court of Chancery, and the Superior Court in January 2020 agreed to do so. West again declined to transfer the case, and instead asked the California court to lift its stay. The California Superior Court did so in June 2020, reasoning that enforcing the forum-selection clause and requiring West to litigate in Chancery would deprive him of his California constitutional jury trial right. West then returned to Delaware and asked the Delaware Superior Court to stay in favor of the California case.

At a December 2020 status conference, the Delaware Superior Court commented on the record, "[M]y prediction is that if this case were to be transferred to the Court of Chancery, and a request made that the entire case be consolidated, because of the request for a jury trial, my assumption would be that a judge on this court would be appointed as vice chancellor to resolve the equity issues, if for no other reason than because this court has, obviously, the experience with jury trials, and we have the staff to handle jury trials. Just from a practical standpoint it makes sense that the Superior Court would handle that aspect…. It appears to me that the California Court when it lifted the stay was under the misimpression that it was not practically or reasonably possible to have a jury trial in this case, and that is simply not accurate. I agree with Defendants that the procedure is somewhat uncertain, but it is not correct that it is unlikely that there will be a jury trial. My impression is that it is likely that there would be a jury trial available on all of the issues."[28]

After further procedural maneuvering, the Delaware Superior Court conducted a jury trial limited to West's breach of contract claim, and the Delaware jury found for the defendants. West appealed, not challenging the jury verdict, but instead attacking the Delaware Superior Court's discretionary decision to continue exercising jurisdiction over the case, notwithstanding the lifting of the stay in California.

In April 2023, the Delaware Supreme Court affirmed. Although no cross-designation ultimately occurred, and there was therefore no occasion for the Supreme Court to comment on the Superior Court's statements on that subject, the Supreme Court's decision noted specifically that West was a sophisticated party who had been aware of the possibility that his agreement to a Delaware forum-selection clause could result in the loss of his jury trial right.[29]

## Navigating the Potential Conflict Between a Delaware Choice of Forum and the California Jury Trial Right

In light of the *BDO USA* and *West* precedents, there is reason to believe that the Delaware courts may be receptive to an application for special designation for the purpose of allowing a jury trial in, or in coordination with, a Chancery proceeding, where the designation is necessary to enforce a valid forum-selection provision notwithstanding a jury demand in California, or in another state with a similar public policy.

Such a situation is at least implicitly contemplated by the Court of Chancery's published Guidelines on special designation. Consider the hypothetical case of a stock purchase agreement between sophisticated parties with access to legal advice, where the parties agree that they will litigate any future disputes arising out of the contract in the Court of Chancery. When a dispute arises, the parties file competing lawsuits for breach of the agreement and damages, one in Chancery and the other in California state court. The California plaintiff then demands a jury trial and invokes *EpicentRx* to argue that the case should remain in California and not in the parties' agreed forum. In this situation, the parties would ordinarily agree that only one of the two actions should proceed, though they would disagree over which one.

In this situation, in the language of the Guidelines, "there are multiple actions at law and equity pending simultaneously, but it makes practical sense for those actions to proceed before one judicial officer, such as … where there is a risk of inconsistent judgments." The party seeking to remain in the California court would undoubtedly face accusations of reneging on an agreement and bad-faith tactical conduct, factors which could move the discretion of the judges in both jurisdictions, and which lead to doubt about whether the California case was "properly filed in the appropriate court in the first instance."

In this scenario, one can imagine that an application for special designation, enabling a single Delaware jurist to sit as both a Vice Chancellor and a Superior Court judge, so that issues triable to a jury can be so tried, might meet a favorable reception.

One can also imagine a potential favorable reception in situations like *EpicentRx* itself, where a stockholder asserting claims falling within the scope of the corporation's forum-selection clause included in the charter or bylaws pursuant to Section 115 brings those claims in California and invokes the California constitutional jury trial right to prevent enforcement of the forum-selection clause. The *EpicentRx* court's analysis hinged on the non-availability of jury trial in the Court of Chancery. But that analysis might turn out differently in a future case if the defendants in the California proceeding are prepared to agree that they will not oppose a request for special designation, so as to enable a jury trial to occur in Delaware, and if there is reason to expect that such a request will be granted.

Litigators whose clients are sued in California (or other jurisdictions with similar public policy with respect to the non-waivability of the civil jury trial right) should consider carefully an appropriate set of steps to enable the courts to respect both an otherwise valid forum-selection provision and a litigant's invocation of the jury trial right. Those steps may include a countersuit in Delaware and a request for special designation, a commitment not to oppose a request for special designation if the opposing party makes one, or simply a statement to the California tribunal that procedural avenues exist in the Court of Chancery to obtain a jury trial under some circumstances, normal equity practice notwithstanding.

From an advance planning perspective, drafters of contracts and entity constitutive documents may wish to consider language channeling future disputes to the Delaware Superior Court as an alternative to the Court of Chancery. Such language could require disputes to be brought in "the Delaware state courts," leaving the choice as among the Delaware state courts to future litigants. Alternatively, such language could provide for exclusive jurisdiction in the Court of Chancery, or in the Delaware Superior Court only if and to the extent transferred to the Superior Court by the Court of Chancery.

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The Delaware courts also may wish to consider formalizing the availability of special designation for the specific purpose of enabling protection of the right to jury trial, whether that right exists due to the nature of the claims at issue or the remedies sought (as in *BDO USA v. EverGlade Global*), or under the applicable laws of another state (as in *EpicentRx*). Such a formalization could take place through further common-law development or through a revision to the March 2023 Guidelines to clarify that protection of a litigant's right to a jury trial, to the extent such a right exists under any applicable law, is a relevant factor in considering an application for special designation.[30]

## Notes

1. *See, e.g.,* Beacon Theatres, Inc. v. Westover, 359 U.S. 500 (1959), and Ross v. Bernhard, 396 U.S. 531, 542 (1970) (in a stockholder derivative case in federal court, the Seventh Amendment guaranteed the corporation a right to jury trial of "its damages against its broker under the brokerage contract and of its rights against its own directors because of their negligence"). For a discussion of the various approaches to this question taken by state courts, *see* Eric J. Hamilton, "Federalism and State Civil Jury Trial Rights," 65 Stan. L. Rev. 851 (2013).
2. Delaware's state constitutional protection for jury trials provides simply, "Trial by jury shall be as heretofore." Del. Const., art. I, § 4. This language, unchanged in Delaware's constitution since 1792, has been interpreted to mean that Delaware "has expressly preserved all of the fundamental features of the jury system as they existed at common law." McCool v. Gehret, 657 A.2d 269, 282 (Del. 1995).
3. *See* 8 *Del. C.* § 115 (authorizing corporations to provide in their certificates of incorporation or bylaws that "any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State"); 6 *Del. C.* § 18-109(d) (members and managers of a limited liability company may agree to "exclusive jurisdiction of the courts of the State of Delaware"); 6 *Del. C.* § 17-109(d) (similar provision for partners of a limited partnership); 6 *Del. C.* § 15-114(d) (similar provision for partners of a general partnership); 12 *Del. C.* § 3804(e) (similar provision for trustees and beneficial owners of statutory trusts).
4. Cal. Const., art. I, § 16.
5. Cal. Civ. Proc. Code § 631(a), (f). Subsection (f) permits parties to waive jury trial by (1) failing to appear at trial, (2) filing a written consent with the clerk or judge, (3) consenting orally in open court, (4) failing to make a timely demand for jury trial, (5) failing to pay the jury trial fee, or (6) failing to deposit the day's fees and mileage for the jury at the beginning of a second or successive day of trial.
6. *See* Grafton Partners v. Super. Ct., 36 Cal. 4th 944 (2005).
7. Handoush v. Lease Finance Group, LLC, 41 Cal. App. 5th 729 (2019).
8. In so ruling, the Court of Appeal drew on prior precedents declining to enforce forum-selection provisions when doing so would impair other non-waivable statutory rights possessed by the litigant opposing dismissal. Those precedents included Wimsatt v. Beverly Hills Weight International, Inc., 32 Cal. App. 4th 1511 (1995) (statutory prohibition on waivers of rights under California franchise law), America Online, Inc. v. Superior Court, 90 Cal. App. 4th 1 (2001) (statutory prohibition on waivers of rights under California consumer protection law), and Verdugo v. Alliantgroup, L.P., 237 Cal. App. 4th 141 (2015) (statutory prohibition on waivers of rights under California Labor Code).
9. EpicentRx, Inc. v. Superior Court, No. D081670 (Cal. Ct. App. Oct. 10, 2023).
10. *Id.,* slip op. at 6-7.
11. *Id.* at 9 (internal quotations omitted).
12. *Id.* at 16.
13. *Id.*
14. *Id.* at 17.
15. *Id.* at 22.
16. Drafters of contracts and entity organizational documents therefore would do well to consider whether it is appropriate to channel disputes uniquely to the Court of Chancery or the Superior Court, to the Delaware state courts in general, or to one specific court with one or more alternatives designated under specific circumstances.
17. *See* 10 *Del. C.* § 1902.

18. Article IV, Section 13 is distinct from other judicial designation processes authorized in the Delaware Constitution, which include provisions for both retired jurists and sitting trial judges to be designated temporarily to sit as members of the Delaware Supreme Court in order to complete a quorum in cases where a sitting justice is disqualified or a vacancy exists. The constitution also contains a provision (Article IV, § 14), enacted before the separate Delaware Supreme Court was created in 1951, authorizing the law judges to grant equitable relief in case of the absence or temporary disability of all the members of the Court of Chancery.
19. Most commonly, this has meant judges of the trial courts who are promoted to the Delaware Supreme Court but continue to preside over certain matters at the trial level. However, special designation has also been used when a judge of one trial court moved laterally to another. *See, e.g.,* Nichols v. Mack Trucks, Inc., 1995 WL 1790686 (Del. Ch. Mar. 24, 1995) (Vice Chancellor sitting by designation as Superior Court judge).
20. 10 *Del. C.* § 341.
21. 10 *Del. C.* § 342.
22. *See* 6 *Del. C.* §§ 17-111 and 18-111 (limited partnerships and limited liability companies, first adopted in 1994); 8 *Del. C.* § 111 and 6 *Del. C.* § 15-122 (corporations and general partnerships, first adopted in 1999). All of these sections have been amended over time to expand the scope of Chancery's jurisdiction.
23. *See https://courts.delaware.gov/forms/download.aspx?id=185928* (last visited Nov. 30, 2023).
24. BDO USA, LLP v. EverGlade Global, Inc., 2023 WL 1371097, at *10 (Del. Super. Jan. 31, 2023).
25. *See* BDO USA, LLP v. JSCo Enters., Inc., 2023 WL 5206150, at *12 (Del. Super. Aug. 8, 2023).
26. *See* Organovo Holdings, Inc. v. Dimitrov, 162 A.3d 102, 114-26 (Del. Ch. 2017).
27. *Id.* at 125.
28. West v. Access Control Related Enters., LLC, No. N17C-11-137-MMJ-CCLD, Tr. at 44-46 (Del. Super. Dec. 9, 2020).
29. *See* West v. Access Control Related Enters., LLC, 296 A.3d 378, 386 (Del. 2023).
30. Other solutions to the conundrum are, of course, possible. California could amend its Civil Procedure Code to overrule *Grafton Partners* and authorize advance waivers of jury trial. Delaware also could consider placing the cross-designation process formally into the Court of Chancery Rules and the Superior Court Civil Rules.

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