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2024 LITIGATION AND SEC ENFORCEMENT OUTLOOK

Emerging Legal Battles and Trends

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Presenters:

- **Viktoriya Torchinsky-Field**

- **Richard A. Levan**

- **Jeffery A. Dailey**

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EMERGING SUPPLY CHAIN EVENTS AND LITIGATION

Emerging Supply Chain Events and Impact

- Issues that create supply chain litigation:
  - Material and component shortages.
  - Natural disasters.
  - Government mandates.
  - Geopolitical conflicts.
  - Civil unrest.
  - Inflationary pressure.
  - Cost increases.

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Emerging Supply Chain Events and Impact (con't)

- What Can You Do To Mitigate Risks?
  - Evaluate your contracts and force majeure clauses.
    - All jurisdictions require the force majeure event to be specifically enumerated or to fall within a catchall provision.
    - Consider listing out all events that could impact your business, including, but not limited to, pandemics, epidemics, supply shortages, government orders, and natural disasters.
  - Improve oversight over contract management.
    - Make sure operation units within the organization that will perform a contract (engineering, finance, etc.) have input.

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Emerging Supply Chain Events and Impact (con't)

- What Can You Do To Mitigate Risks?
  - Ensure your contracts have sufficient incentives for the counterparties to perform contracts with your team when choosing which contracts to breach.
    - Availability of injunctive relief.
    - Attorneys' fees provisions.
    - Payments for failure to perform.

Emerging Supply Chain Events and Impact (con't)

- How to Do Business in the Midst of Litigation?
  - Disputes can emerge while the parties are still doing business with each other and often when they must continue doing business with each other.
  - In those instances, consider delegating point people for the business aspect of the relationship. The parties must understand that the point people are in place for the purpose of getting business done. They should have nothing to do with the litigation.
  - Sometimes, parties agree that any statements made by the point people are not admissible in the litigation.

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BUSTED DEAL LITIGATION

Busted Deal Litigation

- In 2023, the Court of Chancery issued several opinions about buyers seeking to avoid contracts to acquire corporations based on breaches of representations and warranties.

- In two cases that went to trial, the court decided that the buyers were not required to close because the representations and warranties made at signing that were affirmed as true at closing were "flat," *i.e.*, they did not include any materiality element.

- The sellers were obligated to maintain their representations and warranties in all respects, but the court found they did not.

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Hcontrol Holdings LLC v. Antin Infrastructure Partners

- The Court found that the seller's representation regarding its capitalization table was inaccurate.

- While the Court described the financial value of the discrepancy as "minor" and flagged potential reputational issues for the acquirer, it held that Delaware law will enforce the agreements of sophisticated parties and noted that it was not for the court to question the wisdom of the acquirer's decision to terminate.

Restanca, LLC v. House of Lithium, Ltd.

- In this case, the court agreed with the acquirer that multiple breaches occurred regarding representations and warranties made at signing that were affirmed as true at closing.

- The Court found that these breaches were “flat” because they lacked a materiality qualifier.

- The court reiterated that Delaware is a “pro-sandbagging jurisdiction” and rejected an argument that the acquirer should be required to close because it knew at signing that certain representations and warranties had not been satisfied.

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OVERSIGHT LIABILITY

Expansion of Oversight Liability to Officers

- The court expanded oversight liability beyond the board and held that the fiduciary duties of corporate officers also include oversight liability. In re McDonald's Corp. S'holder Deriv. Litig.

  - The Court stated that the scope of liability can vary with the officer's responsibilities. For example, CEOs have responsibility for the entire company and would thus have broader oversight duties than an officer who is responsible for only a part of the company.

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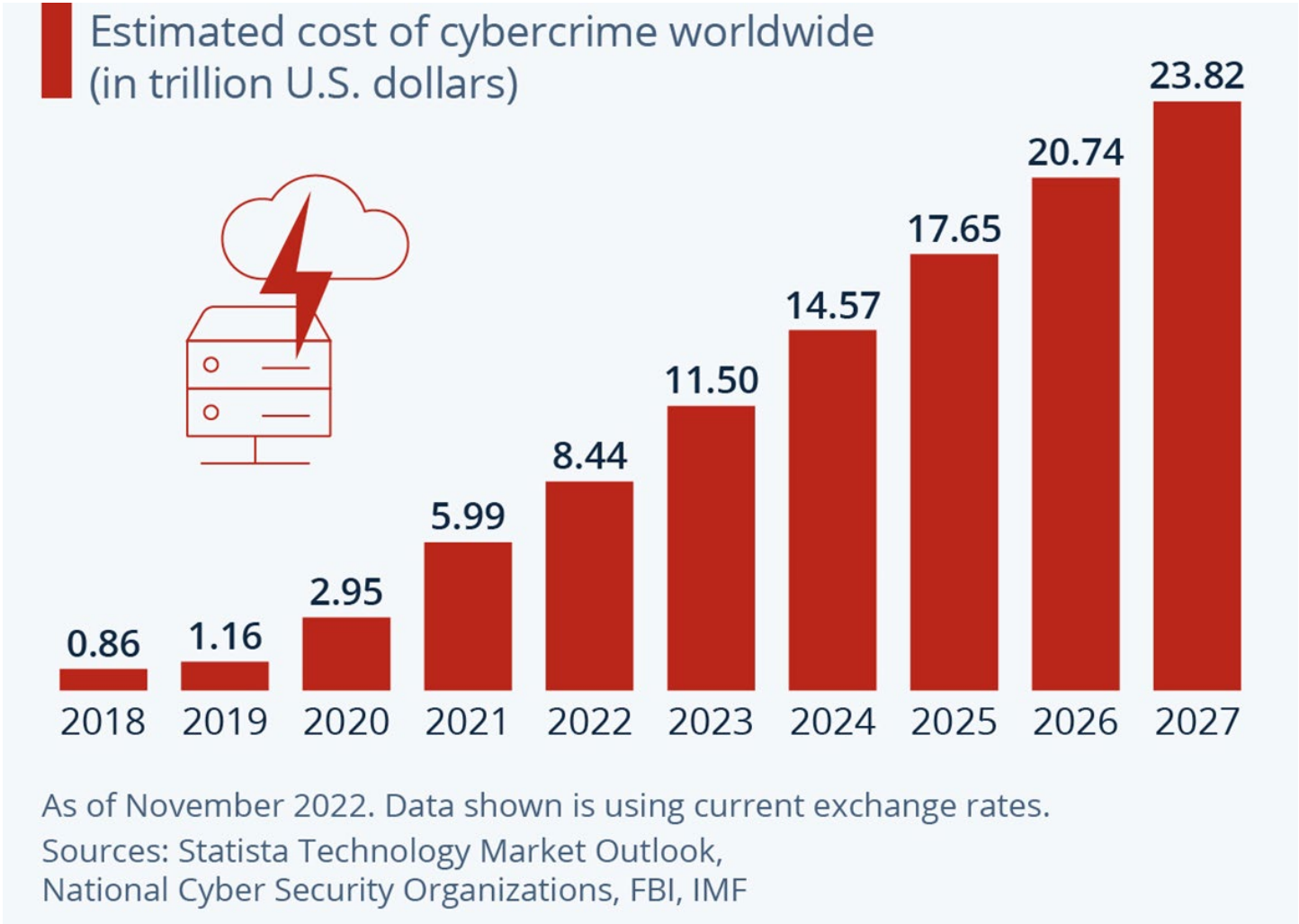
Expansion of Oversight Liability to Officers (con't)

- The court refused to expand oversight liability to cover the management of ordinary "business risk." In re ProAssurance Corp. S'holder Deriv. Litig.

- The Court also dismissed a derivative action containing oversight claims that had previously survived a motion to dismiss after the corporation established a special litigation committee to investigate those claims, conducted an exhaustive seven-month investigation and concluded that the claims should not continue. Teamsters Local 443 Health Servs. & Ins. Plan v. Chou.

FINANCIAL CYBERCRIME

Financial Cybercrime



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Financial Cybercrime – Litigation Counsel Proactive Steps

- Develop an Asset Recovery Protocol that includes, among other things:

1. Identification of the internal and outside counsel that should be contacted immediately upon discovery of event.
2. When and how to notify the FBI's Financial Fraud Kill Chain, federal law enforcement, the United States Secret Service, iC3, or other authorities.
3. If necessary, steps to take to obtain a criminal or civil freeze over any money in transit to prevent it from moving further.
4. Notification of any applicable insurer.
5. Notification of any affected third-parties.

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SEC ENFORCEMENT ACTIONS INVOLVING EMPLOYERS

WHISTLEBLOWER ACTIVITY

- 2023 was record year for whistleblower awards
- $600M in awards disbursed
- Over 18,000 tips received

PROHIBITED EMPLOYER CONDUCT

- Employers cannot require employee to:
- Attest that they have not filed a complaint against the employing firm with any federal agency.
- Waive the employee's rights to financial whistleblower awards.
- Provide notice to the employing firm if they receive a request for information from the SEC staff after they depart the firm.
- Explicitly or implicitly waive any other meaningful protections under Dodd Frank

SEC ENFORCEMENT ACTIONS INVOLVING EMPLOYERS

- Activision Blizzard Inc.
- Gaia, Inc.
- Monolith Resources LLC (privately held)
- D. E. Shaw & Co. L.P.

Activision Blizzard, Inc. – February 3, 2023

- The SEC's order found that Activision Blizzard executed separation agreements in the ordinary course of its business that violated a Commission whistleblower protection rule by requiring former employees to provide notice to the company if they received a request for information from the Commission's staff.

- The SEC's order also found that Activision Blizzard failed to implement necessary controls to collect and review employee complaints about workplace misconduct, which left it without the means to determine whether larger issues existed that needed to be disclosed to investors.

- $35 million penalty imposed

Gaia, Inc. – May 23, 2023

- Retaliated against a whistleblower who reported financial misconduct – the falsification of company subscriber numbers -- both internally to Gaia management and to the Commission, when it terminated the whistleblower "for cause."

- In addition, Gaia included provisions in 23 employee severance agreements that required employees to forgo any monetary recovery in connection with providing information to the Commission, and thereby impeded individuals from communicating directly with Commission staff about possible securities law violations.

- $2 million penalty imposed

Monolith Resources LLC – September 8, 2023

- Used separation agreements that required certain departing employees to waive their rights to monetary whistleblower awards in connection with filing claims with or participating in investigations by government agencies.

- The SEC's order found that Monolith's separation agreements raised impediments to participation in the SEC's whistleblower program by having employees forego important financial incentives that are intended to encourage people to communicate directly with SEC staff about possible securities law violations.

D. E. Shaw & Co. L.P.– September 29, 2023

- Required new employees to sign agreements that prohibited them from disclosing confidential information to anyone outside the company unless authorized by D. E. Shaw or required by law or court order.

- Confidential information was broadly defined to include any information gained in the course of employment that could reasonably be expected to be damaging to D. E. Shaw if disclosed to third parties.

- Required approximately 400 of its departing employees to sign releases affirming that they had not filed any complaints with any governmental agency, department, or official in order for them to receive deferred compensation and other benefits sometimes worth millions of dollars.

Whistleblower Protections Apply to Clients Too

- On January 16, 2024, the SEC fined JP Morgan Chase & Co. **$18 million** for using client confidentiality agreements that the SEC claimed violated whistleblower protections.

- JP Morgan insisted that clients settling complaints worth more than $1,000 sign confidentiality agreements agreeing not to report the settlements to regulators.

- ***ANY*** restraints on reporting wrongdoing are inherently suspect and likely actionable.

SEC ENFORCEMENT TRENDS

2023 SEC ENFORCEMENT TRENDS

- The Securities and Exchange Commission (SEC) has released its annual enforcement results for 2023
- The results indicate near record-breaking levels of enforcement actions, financial penalties, and barring of senior executives
- Regulatory trends reflected by the results include increased focuses on recordkeeping, off-channel communications, individual accountability and restrictions on whistleblowers

NEAR-RECORD ENFORCEMENT TOTALS

- Filed **784 total enforcement actions,** representing a **3% increase** over fiscal year 2022
- The total included **501 "stand-alone"** enforcement actions, which is **an 8% increase** over the previous fiscal year
- The regulator also filed **162 "follow-on"** proceedings aiming to bar or suspend individuals
- Approximately two-thirds of the SEC's cases involved charges against one or more individuals.

NEAR RECORD FINES AND PENALTIES

- The SEC obtained orders for over **$4.9 billion in financial remedies** – the second highest amount in history after FY22
- The remedies comprised over **$3.3 billion** in disgorgement and prejudgment interest and over **$1.5 billion** in civil penalties – again, both the second highest amounts on record
- The regulator obtained orders **barring 133 individuals** from serving as officers and directors, the highest number of officer and director bars obtained in a decade

SEC STANCE ON INDIVIDUAL LIABILITY – The Message

According to SEC Chair Gary Gensler, "nothing motivates quite like accountability"

SEC STANCE ON INDIVUAL LIABILITY – The Reality

- Reality is far more nuanced than the message.
- In fiscal year 2023, approximately two-thirds of the SEC's cases involved charges against one or more individuals.
- In addition, the SEC obtained 133 orders barring individuals from serving as officers and directors of public companies, the highest number in a decade.

SEC STANCE ON COMPLIANCE OFFICER LIABILITY

In remarks to the NYC Bar Association Compliance Institute, SEC Enforcement Chief Gurbir Grewal emphasized that enforcement actions against compliance officers are "exceedingly rare" because the commission has "no interest" in pursuing actions against compliance personnel who act reasonably or in good faith.

SEC STANCE ON COMPLIANCE OFFICER LIABILITY

According to Grewal, the Enforcement Division may recommend that the commission charge a compliance officer when the individual:

- Affirmatively engages in misconduct unrelated to their compliance function.
- Purposely misleads regulators.
- Entirely fails to carry out their compliance responsibilities.

SEC v. SolarWinds, et al. – October 30, 2023

On Oct. 30, the U.S. Securities and Exchange Commission filed a high-profile lawsuit asserting fraud and internal controls charges against software company SolarWinds Corp. and its chief information security officer, Timothy G. Brown, in connection with a massive 2020 breach of SolarWinds' network monitoring software system, Orion.

SEC v. SolarWinds, et al. – October 30, 2023

- SolarWinds provides various information technology management services to customers.
- SEC alleges the company exaggerated the steps it took to prevent cybersecurity incidents and then failed to tell the whole truth after it learned of a massive breach of its signature network monitoring system that affected many of its key customers.
- Those affected by the breach included government agencies such as the Pentagon and the U.S. Department of State, as well as a wide range of private companies.

SEC v. SolarWinds, et al. – October 30, 2023

- The SEC's case against Brown centers on allegations that he was aware of critical cybersecurity deficiencies, even as the company's public statements and SEC filings — including statements and filings Brown helped create and approve — concealed those deficiencies and mischaracterized the strength of SolarWinds' cybersecurity practices.

- "As you guys know our backends are not that resilient and we should definitely make them better.“

- FTD numerous ***prior*** cyber breaches.

SEC v. SolarWinds – Key Takeaways

- The SEC is taking a more aggressive stance toward cybersecurity enforcement **– *including against individual officers.***
- Companies should assess their cybersecurity statements — both *internal* and *external* — regarding the products, services and software that are core to their business.
- CISOs should understand their disclosure and controls obligations, and their exposure with respect to cybersecurity.
- Information security personnel must be aware that their emails and other internal communications will likely be subject to scrutiny in the wake of a breach.

SEC v. SolarWinds – One Final Point

Corporate officers should not exercise and sell company stock options while committing a cyber breach or the SEC will allege the sale of the options was a motive for false and/or misleading disclosures!

Sarbanes-Oxley Act § 304 and Rule 10D-1

Navigating Clawbacks as General Counsel

Introduction

- Enacted in the early 2000s in response to high-profile corporate scandals (Enron, WorldCom), the Sarbanes-Oxley Act of 2002 § 304 contains a "clawback" provision designed to ensure financial integrity and executive accountability within corporations
- SOX § 304 establishes a legal framework to disgorge executive incentive- or equity-based compensation in cases of financial misconduct but, historically, the SEC has sporadically enforced the statute
- In 2022, the SEC enacted Rule 10D-1 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which requires national securities exchanges and associations to establish listing standards related to the recovery of erroneously awarded compensation
- Whereas SOX 304 establishes the statutory framework for executive officer clawbacks, SEC Rule 10D-1 complements SOX 304 by providing detailed requirements for the implementation of recovery policies related to incentive-based compensation for a broader group of executives, as mandated by Dodd-Frank.

Sarbanes-Oxley Act § 304 and Rule 10D-1

Navigating Clawbacks as General Counsel

Scope	Monies Subject to Recovery	Recovery Period
• **SOX § 304:** Only applies to CEOs and CFOs • **Rule 10D-1:** Applies to current and former executives, including president, principal financial officer, principal accounting officer, controller, vice president in charge of a principal business unit, division or function, and any other officer or person who performs a policy-making function. At a minimum, it includes all those listed as executive officers pursuant to 17 CFR 229.401(b).	• **SOX § 304:** (i) "any bonus or other incentive-based or equity-based compensation received…" § 304(a)(1); and (ii) "any profits realized from the sale of securities…" § 304(a)(2) • **Rule 10D-1:** "…[']erroneously awarded compensation[']…" which is the "amount of incentive-based compensation received that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts, and must be computed without regard to any taxes paid." §240.10D-1(b)(iii)	• **SOX § 304:** 12-month period following the "first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement…" § 304(a)(1) • **Rule 10D-1:** 3 completed fiscal years prior to the date that an issuer is required to prepare an accounting restatement (the earlier of: (A) The date the issuer's board of directors (or other authorized committee) concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement…; or (B) The date a court, regulator, or other legally authorized body directs the issuer to prepare an accounting restatement…). §240.10D-1(b)(ii).

Sarbanes-Oxley Act § 304 and Rule 10D-1

Navigating Clawbacks as General Counsel

Clawback-Triggering Events	Scienter	Misconduct
• **SOX § 304:** Only if enforced by the SEC. Although not expressly stated in the statute, clawbacks under SOX § 304 have historically been triggered only by "Big R" restatements • **Rule 10D-1:** Triggered as soon as a restatement is required under the Rule. Although not expressly stated in the statute, clawbacks under Rule 10D-1 apply to both 'little r" and "Big R" restatements	• **SOX § 304:** Strict Liability; No express requirement that CEO/CFO was involved in, or had knowledge of, the underlying misconduct • **Rule 10D-1:** Same. Focuses on objective impact of material noncompliance rather than subjective intent or knowledge of executives involved in reporting process	• **SOX § 304:** material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws (15 U.S.C. § 7243(a). • **Rule 10D-1:** material noncompliance of the issuer with any financial reporting requirement under the securities laws. §240.10D-1(b)(1).

Sarbanes-Oxley Act § 304 and Rule 10D-1

Navigating Clawbacks as General Counsel

The SEC has sporadically invoked SOX 304 in the years since enactment, but we have seen increased enforcement in recent years:

- **2021:** WageWorks, Inc. CEO agreed to reimburse nearly $2 million and CFO agreed to reimburse over $250,000 (in addition to civil penalties) where SEC alleged that executives made false and misleading statements to company accountants that caused WageWorks to record millions in revenue that was not realizable or reasonably assured (and therefore a violation of accounting principles*). In the Matter of Joseph Jackson & Colm Callan, Respondents*, Release No. 4202 (Feb. 2, 2021).

- **2022:** Former senior executives of Granite Construction Inc. were ordered to return nearly $2 million in bonuses and compensation in connection with Granite restating its financials following misconduct by another former official. *SEC v. Granite Construction Inc.*, No. 5:22-cv-04857 (N.D. Cal. 2022); *SEC v. Swanberg*, No. 5:22-cv-04859 (N.D. Cal. 2022).

- **2022:** Founder and former CEO of technology company Synchronoss Technologies Inc. agreed to reimburse the company more than $1.3 million in stock sale profits and bonuses as well as return previously granted shares of company stock pursuant to SOX 304. *SEC v. Rosenberger et al.,* No. 1:22-cv-04736 (S.D.N.Y. 2022).

- **2023:** Former CFO of Osiris Therapeutics, Inc. was ordered to return $223,965.88; former executives of MusclePharm Corp. disgorged almost $100,000.00 after being charged with violating SOX 304. *SEC v. Osiris Therapeutics, Inc., et al*., No. 17-cv-03230 (D. Maryland 2017); *SEC v. Casutto et al.,* No. 2:23-cv-05104 (C.D. Cal. 2023); *SEC v. Drexler,* No. 2:23-cv-05102 (C.D. Cal. 2023).

Sarbanes-Oxley Act § 304 and Rule 10D-1

Navigating Clawbacks as General Counsel

Key Takeaways for General Counsel

- SOX § 304 creates a nuanced legal landscape, demanding strategic engagement from General Counsel
- Rule 10D-1 expands the clawback territory originally constrained by SOX 304 by requiring issuers to adopt certain policies to clawback erroneously awarded compensation
- Companies subject to SOX 304 must also comply with the listing standards established by national securities exchanges under Rule 10D-1, ensuring that their recovery policies align with the SEC's requirements and exchange rules.
- A large swatch of executives are subject to clawbacks under SOX 304 and Rule 10D-1 for inaccuracies in financial reporting, even if they were not aware of or involved in the misconduct – and the financial penalties are severe
- Counsel should advise clients to: (1) ensure company compliance with relevant accounting principles and disclosure requirements under 10D-1; (2) ensure that appropriate internal disclosure controls are in place and adhered to; (3) create an office environment where employees can comfortably raise potential concerns; and (4) continue to routinely revisit internal controls for compliance with accounting principles

New Frontier in Insider Trading – SEC v. Panuwat (pending)

- "Shadow Trading" case
- Involved a corporate insider trading in the securities of a ***competitor***
- First-of-its-kind SEC case
- Prior to Panuwat, SEC pursued traditional forms of insider trading (classical & misappropriation)
- Panuwat represents a sea change in scope of SEC insider trading cases
- We'll discuss what companies need to do to comply

FACTS OF PANUWAT

- Panuwat was head of business development at MEDIVATION, a mid-cap bio-pharma company
- Sector was experiencing consolidation with few similar competitors
- Medivation, in response to a hostile takeover bid by Sanofi, conducted a study of similar firms as potential takeover targets
- Medivation identified Incyte Corp. as another possible Sanofi takeover target
- Panuwat bought INCYTE stock prior to announcement of takeover bid of Incyte by Sanofi

RULING IN PANUWAT

- Panuwat moved for summary judgement claiming he could not be liable for trading in the securities of a ***competitor*** firm
- Court (N.D. Cal.) rejected Panuwat's claims ruling that the SEC's theory of insider trading was legally sufficient to present to a jury
- Case still pending – no decision on the merits

TAKEAWAYS FROM PANUWAT

- Companies should amend their insider trading policies to prohibit trading in ***any*** company's stock while in possession of MNPI obtained through employment

- Legal & Compliance should consider adding companies to restricted list when they share a sufficient market connection

- Employees should be trained in handling MNPI and should be encouraged to elevate to Legal & Compliance situations like Panuwat

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PRIVATE COA FOR ITEM 303 OMISSIONS?

- The U.S. Supreme Court seems poised to curtail the ability of investors to sue corporate management for allegedly failing to warn them of future business hurdles.

- This month the Court heard oral arguments in a case known as ***Macquarie Infrastructure Corp. v. Moab Partners LP,*** in which it is being asked to determine whether a company can be sued for failing to warn investors about the anticipated financial ramifications of a soon-to-be implemented regulation.

- An omissions case: does the Item 303 disclosure omission render a prior or contemporaneous statement misleading?

Contact

- Viktoriya Torchinsky-Field -- Viktoriya.Torchinsky-Field@avantorsciences.com
- Richard A. Levan – ralevan@DaileyLLP.com
- Jeffery A. Dailey – jdailey@DaileyLLP.com

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