Best Practices For Auto Boards During Industry Revolution

By **Justin Savage and Ike Adams** (August 9, 2022)

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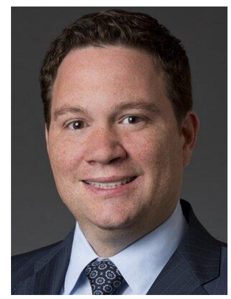

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Last summer, in U.S. v. Milton, the federal government indicted Trevor Milton, the founder and then-CEO of electric vehicle startup Nikola Corporation, in the U.S. District Court for the Southern District of New York for securities and wire fraud.

Milton was charged with lying about nearly every aspect of the business to investors — including allegations the Nikola One semitruck worked, when in reality the closest it had come to driving was when company engineers rolled a prototype down a hill so it could be filmed for a commercial.

For its part, Nikola reached a settlement with the U.S. Securities and Exchange Commission, agreeing to pay a $125 million fine without admitting or denying the SEC's allegations.

In addition, in Rhodes v. Milton, a shareholder is now suing the company's directors in the Court of Chancery of the State of Delaware, claiming they breached their fiduciary duties because they were blind to the fraud perpetrated by Milton.

The suit is in keeping with other In re: Caremark International Inc. Derivative Litigation cases that allege that corporate directors breached their fiduciary duties by failing to exercise adequate oversight.

In the past three years, Delaware courts have allowed six such cases to survive motions to dismiss, including most recently a claim against The Boeing Company's directors over their oversight of the 737 Max crisis in the case In re: Boeing Co. Derivative Litigation in the Delaware Court of Chancery. This emerging body of case law puts to bed the notion that Caremark represents an insuperable barrier to recovery against directors.

The evolving nature of the Caremark standard governing board oversight comes at a particularly challenging time for the auto and mobility industry, which faces unprecedented change from electric vehicles, autonomous vehicles and many other revolutionary technologies.

Automotive boards would do well to understand how the Caremark standard might apply to them in this unprecedented business and legal climate and how to manage these risks.

Risks and Challenges Facing the Automotive Industry and Company Boards

The Nikola case stands at the intersection of several emerging risk areas in the automotive industry. For example, as regulators in the U.S. and European Union continue to ratchet up the pressure on climate change goals, and environmental, social and corporate governance, boards need to be extra careful about their companies' commitments to going carbon neutral and the efficacy of electric vehicles.

That means putting clear plans and metrics in place to ensure appropriate follow-through and effective communications with investors so that they are well-informed about the caveats, risks and limitations.

Automotive companies must also regularly engage with many regulatory agencies — be it the SEC, the U.S. Environmental Protection Agency, the U.S. Department of Transportation or the National Highway Traffic Safety Administration — many of which collaborate with one another.

Boards need strategies not only to handle investigations and inquiries from such regulators — around safety, emissions and a number of other areas — but to seize business opportunities stemming from the regulations themselves. Tesla Inc., for example, has been able to generate profits by selling zero emissions regulatory credits to other automakers.

Despite the critical nature of regulatory compliance, automotive boards might struggle to provide effective oversight, due to two main obstacles: regulatory complacency and information overload.

On the former front, there's a risk in assuming the world tomorrow will be the same as it's always been, as regulations are constantly evolving — whether it is the SEC's task force on environmental, social and corporate governance, its climate disclosure proposal, new environmental laws, government incentives for electric vehicles or the growing number of data privacy regulations.

At the same time, the overwhelming amount of information about new technologies and practices, especially in highly regulated spaces, risks overdeference to management.

Best Practices for Withstanding Regulatory Scrutiny

Coupled with broader principles of corporate governance, automotive boards can manage information overload and regulatory complacency, mitigate their risks and get out ahead of potential liability. Here are four best practices to consider:

Effectively and periodically identify mission-critical risks.

Mission-critical risks are those that could materially impact the company's ability to achieve its long-term goals and objectives. These can encompass a broad range of issues, especially in the highly regulated automotive industry.

Obvious examples include regulatory compliance and safety. But as noted above, new mission-critical risks are on the horizon, whether they're related to talent shortages, cybersecurity, emissions, or environmental, social and corporate governance.

Remember that courts are emphasizing the context-dependent nature of oversight, meaning these mission-critical risks must relate to a company's particular context. Information, reporting and compliance systems must then be built specifically for the purpose of rigorously monitoring these risks.

Put the right structure in place to manage mission-critical risks.

The vast majority of companies rely on their audit committee to oversee compliance regulatory risks and have not adjusted their governance structures by forming specifically dedicated risk committees, science and technology committees, or environment, health and safety committees.

Specialized committees focused on, for example, safety or climate risks, can bring heightened attention to critical areas, all while sending a message to investors and regulators that the board is really concentrating on these key issues.

In establishing such committees, boards should take pains to nominate directors with relevant expertise and draft committee charters that clearly reflect the responsibilities delegated for compliance, safety and other mission-critical risks.

Establish the right oversight processes.

Plaintiffs will often ask for books, records and meeting minutes before they file their claim, and these documents can be used to allow them to withstand a motion to dismiss. That means it is important to carefully document the board's oversight efforts.

This might entail reviewing the board's reporting processes to ensure that information about mission-critical risks is brought to the board's attention in a manner not overly dependent on management discretion. It also might involve establishing a regular cadence for discussion of such risks at board meetings.

Ensure board members are qualified in relevant areas.

In the Boeing case, the lack of aviation safety expertise on the board was a significant issue, leading to the addition of a new board member with aviation experience as part of the settlement. Yet, given the range of potential mission-critical risks for automotive companies, the diversity of the board matters, too.

Consider developing a well-rounded board with experts who understand various mission-critical risks, be it related to safety, the environment, supply chain or electric vehicles.

Finally, as scrutiny of automotive boards intensifies, directors can't afford to rest on their laurels. They should be continually assessing emerging and existing risks — and seeking new and improved ways to manage them.

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