August 2019

Board Oversight: Why Directors Must Care About *Caremark*

In a recent case, the Delaware Supreme Court reversed the dismissal of a shareholder derivative suit that seeks to hold directors personally liable for failing their duty of oversight. Writing for the court, Chief Justice Leo E. Strine, Jr., held that the plaintiff sufficiently alleged that the directors had completely failed to implement any system to monitor the company's food safety performance or compliance. The decision is a rare example in which a so-called "*Caremark* claim" for breach of the duty of oversight has survived a motion to dismiss.

Background

Executive Summary

- Under the seminal 1996 decision in *Caremark*, a board of directors' duty of oversight requires a good faith effort to implement and monitor a reasonable system of internal controls.
- Since 1996, *Caremark* claims have been among the most difficult for plaintiffs to bring. Delaware courts have routinely rejected such claims, even following significant corporate crises such as the subprime mortgage crisis.
- In *Marchand*, however, the Delaware Supreme Court upheld a claim brought against the board of directors of Blue Bell Creameries USA, Inc., following a listeria outbreak that caused the death of several customers.
- The supreme court said the plaintiff's allegations supported an inference that the board had not made any attempt to monitor food safety and had not received any notifications of compliance failures leading up to the crisis.
- *Marchand* offers important guidance for directors in establishing *board-level* oversight and prioritizing key risks, which may include, among other things, forming board committees, routinely devoting portions of regular board meetings to discussing key compliance issues, and using meeting minutes to document the board's oversight and compliance efforts, especially on *"mission critical"* issues.

Marchand v. Barnhill involved a stockholder derivative lawsuit brought against the board of directors of Blue Bell Creameries USA, Inc., after a 2015 listeria outbreak caused the deaths of several consumers and led to a product recall and liquidity crisis for the company.[1] Following a books and records inspection, the stockholder-plaintiff filed a complaint against the directors and senior officers alleging a series of compliance failures with various FDA and food safety laws preceding the listeria outbreak. The plaintiff also alleged that Blue Bell's board of directors never received reports on the compliance failures or any other food safety matters. In addition, none of the minutes of board meetings cited by the plaintiff suggested that the board ever discussed food safety. The plaintiff claimed that the board had breached its fiduciary duty of loyalty by completely failing to oversee food safety at the company. The Court of Chancery dismissed the lawsuit, and the plaintiff appealed.

[1] *Marchand v. Barnhill*, No. 533, 2018 (Del. June 19, 2019).

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Holding

The Delaware Supreme Court held that the plaintiff had adequately pled a *Caremark* claim that the directors had acted in bad faith and breached their duty of loyalty by completely failing to ensure a reasonable information and reporting system existed. In reaching its conclusion, the supreme court considered the plaintiff's allegations that:

- "no board committee that addressed food safety existed;
- no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks, or reports existed;
- no schedule for the board to consider on a regular basis, such as quarterly or biannually, any key food safety risks existed;
- during a key period leading up to the deaths of three customers, management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board;
- the board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture; and
- the board meetings are devoid of any suggestion that there was any regular discussion of food safety issues."[2]

In addition, the court noted that following the listeria outbreak an FDA inspection discovered "a number of systematic deficiencies in all of Blue Bell's plants… that might have been rectified had any reasonable reporting system that required management to relay food safety information to the board … been in place."[3]

Based on these allegations, the supreme court held that the complaint "supports an inference that no system of board-level compliance monitoring and reporting existed at Blue Bell." The supreme court also emphasized that the allegations went to a "compliance issue intrinsically critical to the company's business operation."[4] In reversing the lower court, the supreme court said that while *Caremark* is a high standard for director liability, it is not a "chimera" and it requires that directors make "make a good faith effort" and *"try"* to put in place "a reasonable board-level system of monitoring and reporting."[5]

Other Recent Oversight Developments in Delaware

Since *Marchand*, the Delaware Court of Chancery has issued two rulings on director oversight claims, both of which were favorable to the director-defendants. First, in *Hays v. Almeida*, Vice Chancellor J. Travis Laster dismissed claims brought against Walgreens Boots Alliance, Inc.'s board of directors related to the company's commercial relationship with Theranos, Inc., a well-known start-up that was shuttered following allegations of fraud.[6] The court held that the stockholder-plaintiff failed to plead the directors had actual knowledge of any "red flags." In addition, the court observed that the company's contract with Theranos obligated Theranos to maintain various government certifications.

Second, in *Rojas v. Ellison*, Chancellor Andre G. Bouchard dismissed a complaint alleging that J.C. Penney Company, Inc.'s directors had breached their fiduciary duties by failing to oversee the company's

[2] *Id.* at 32.
[3] *Id.* at 33.
[4] *Id.*
[5] *Id.* at 36, 30 (emphasis added).
[6] *Hays v. Almeida*, C.A. No. 2018-0728-JTL, order (Del. Ch. July 26, 2019).

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compliance with price-comparison advertising laws.[7] The court said that the complaint did not create an inference that the directors consciously allowed the company to violate any such law.

Takeaways

Marchand is a significant case for several reasons. First, *Caremark* claims rarely survive motions to dismiss. Thus, a successful claim – particularly when brought against the board of a publicly traded company – deserves attention. Second, the supreme court's opinion was authored by Chief Justice Strine, who recently announced his retirement. *Marchand* may be Chief Justice Strine's way of leaving his mark on the duty of oversight, especially in today's political environment, which seeks to hold corporations and their directors and officers more accountable. Thus, there are several key takeaways from the decision.

***Caremark* Claims Are Difficult but Not Impossible to Plead**

A *Caremark* claim seeks to hold directors personally liable for failing their duty of oversight,[8] typically by alleging that they breached the duty of loyalty by completely failing to implement and oversee a reasonable system of internal controls and procedures. The Delaware courts have said that a *Caremark* claim "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[9] *Marchand* is a rare but important reminder that well-pled *Caremark* claims can survive a motion to dismiss, where the court must assume the allegations are true and draw all reasonable inferences in favor of the plaintiff.

***Caremark* Claims Do Not Require Actual Knowledge of Misconduct or "Red Flags"**

The decision indicates that directors' "lack of attentiveness" may rise to the level of "bad faith indifference" required to state a *Caremark* claim. The plaintiff did not allege that the directors consciously ignored red flags or actually knew the company's operations were violating the law. Rather, the plaintiff argued that the directors were ignorant of red or yellow flags that might have prompted them to take corrective action. Thus, the complaint alleged – and, for pleading purposes, the supreme court agreed – that the directors breached their fiduciary duties not by ignoring troubling information, but by making no attempt to oversee food safety and obtain any such information.

***Marchand* Focused on *Board-Level* Oversight and Controls**

Caremark has always required boards of directors to implement and oversee reasonable controls within the context of the company's circumstances. The critical part of *Marchand* arguably is the supreme court's strong focus on whether the controls are funneling critical information directly to the board. For example, the supreme court was not persuaded that the board had discharged its oversight obligations based solely on the presence of management-level internal controls, which allegedly did not report key information to the board about the results of FDA inspections, food safety risks, and other legal noncompliance. "[T]he fact that Blue Bell nominally complied with FDA regulations," the supreme court wrote, "does not imply that the *board* implemented a system to monitor food safety *at*

> "[T]he complaint pleads particular facts supporting an inference that during a crucial period when yellow and red flags about food safety were presented to management, *there was no equivalent reporting to the board and the board was not presented with any material information about food safety*."

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[7] *Rojas v. Ellison*, C.A. No. 2018-0755-AGB, mem. op. (Del. Ch. July 29, 2019).

[8] Pursuant to Section 102(b)(7) of the Delaware General Corporation Law, most Delaware corporations exculpate their directors for liability for violations of the duty of care. As a result, plaintiffs must provide that directors breached their duty of loyalty in order to hold them personally liable.

[9] *Stone v. Ritter,* 911 A.2d 362, 372 (Del. 2006) (internal quotation marks omitted); *see also Guttman v. Huang,* 823 A.2d 492, 506 (Del. Ch. 2003) ("A *Caremark* claim is a difficult one to prove."); *In re Caremark Int'l Inc. Derivative Litig.,* 698 A.2d 959, 967 (Del. Ch. 1996) ("The theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.").

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the board level."[10] This is not a departure from Delaware law, in which prior *Caremark* decisions have referred to periodic reporting to boards or board committees, but board-level oversight is an important point of emphasis.

Practical Steps for Boards

"*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort – i.e., try – to put in place a reasonable board-level system of monitoring and reporting."

Marchand is not a radical change in Delaware law that will open the floodgates of personal liability for corporate directors. After all, Delaware courts recognize that even the best compliance programs and internal controls are imperfect.[11] In addition, the Court of Chancery will typically require allegations that the directors consciously ignored their duties, as evidenced by its post-*Marchand* rulings in *Hays* and *Rojas*, both of which were favorable to the director-defendants, as discussed above. Also, companies should remember that *Marchand* is merely a pleading-stage case in which the plaintiff's allegations are assumed to be true and the defendants have not yet had the opportunity to introduce evidence rebutting the claims.

Nevertheless, *Marchand* is an important reminder that directors must make a good-faith effort (*i.e.*, try) to ensure a reasonable system of controls and procedures are in place – a task that may be challenging in a complex and dynamic market. *Marchand* also provided several suggestions for boards to consider. In light of the supreme court's decision, boards should consider the following steps:

- ***Prioritize and Focus on Key or "Mission Critical" Risks in a Contextualized Manner.*** First, the supreme court noted that "directors have great discretion to design context- and industry-specific approaches tailored to their companies' business and resources."[12] Thus, there is no "one size fits all" approach, and many cost-benefit analyses as to compliance measures should be protected by the business judgment rule. Second, board oversight should focus on key risks facing the company, such as "compliance issue[s] intrinsically critical to the company's business operation."[13] In *Marchand*, the supreme court emphasized that Blue Bell was a monoline company and "food safety was essential and *mission critical*."[14] Obviously, risks that involve death or injury require the highest level of attention from the board.

- ***Periodically Revisit and Update Controls as Necessary.*** Boards and companies should ensure that their internal controls are periodically evaluated and updated as needed based on company- and industry-specific issues. For example, if a company learns about a significant compliance issue at a competitor, that company should revisit its own system of controls to provide board-level oversight. Similarly, risk factors described by public companies in their SEC filings can help identify key regulatory and business risks within the same industry and thereby guide board oversight priorities.

- ***Consider Forming a Standing Committee of the Board.*** In upholding the complaint, *Marchand* noted the absence of a board committee to oversee food safety. To be clear, boards are not required to form committees to discharge their fiduciary duties. Many boards, however, may find that delegating specific oversight functions to a committee is an effective and efficient way to monitor key risks. In addition, forming a committee may help document the board's oversight process.

[10] *Marchand*, mem. op. at 34 (emphasis in original).

[11] *See id.* at 31 ("[W]e are not examining the effectiveness of a board-level compliance and reporting system after the fact"); *id.* ("[O]ur case law gives deference to boards and has dismissed *Caremark* cases even when illegal or harmful company activities escaped detection, when the plaintiffs have been unable to plead that the board failed to make the required good faith effort to put a reasonable compliance and reporting system in place.").

[12] *Id.* at 30; *see also Caremark*, 698 A.2d at 970 (stating that "the level of detail that is appropriate for such an information system is a question of business judgment").

[13] *Marchand*, mem. op. at 33.

[14] *Id.* at 36 (emphasis added).

- ***Board Agendas Should Regularly Include Compliance Reporting.*** Board agendas and meeting schedules should require periodic reporting to boards or applicable committees on key oversight issues. The *Marchand* court focused on whether systems of control were adopted by the board rather than management's discretionary reports provided to the board. How often a board requires reports (*e.g.*, quarterly, semi-annually) and from whom (*e.g.*, the general counsel, chief compliance officer, chief risk officer, outside counsel) will depend on the specific issues facing the company and the magnitude of the risk.

- ***Ensure Regular Reporting of Key Information to Boards.*** In addition to devoting specific portions of board meetings to legal and compliance issues as indicated above, companies should consider adopting a regular protocol requiring board-level reports about key risks. Effective oversight relies on balanced information, not only favorable information as reported to the board in *Marchand* but also red and yellow flags, such as the results of government investigations or inspections, internal audit findings, or other material issues. In *Marchand*, for example, the plaintiff alleged that the board did not receive official notice of food safety deficiencies for years after issues were first identified, despite notices to management from regulators.

- ***Review Internal Capabilities and Use Third Parties When Appropriate.*** Boards should periodically evaluate whether sufficient internal resources are being devoted to critical compliance issues and whether the company has employees with the requisite expertise. This may be particularly important for fast-growing companies or companies entering new industries or markets. *Marchand* also noted that boards can engage third-party monitors, auditors, and consultants to help structure or test internal controls and evaluate corporate compliance.

- ***Focus on Board Composition and Expertise.*** A board should regularly assess its composition to ensure that the board (and relevant committees) have an appropriate combination of experience and qualifications. If necessary, the board should add directors with specialized expertise on mission critical issues and specialized regulatory and compliance requirements.

- ***Document the Board's Oversight.*** A critical issue in *Marchand* was that, as pled by the plaintiff, none of the board minutes referred to any discussions of food safety, whether generally or specifically as to compliance failures predating the company's crisis. The court rejected the defendants' argument that the board had met its oversight function when the minutes indicated the board was updated on "operational issues." Thus, board and committee meeting minutes should be used to help document the board's oversight function in specific terms. Other reporting processes discussed above can also build a record evidencing the board's oversight.

- ***Address Instances of Noncompliance Promptly and Fund Compliance.*** Board oversight should cover regulatory and other risks and instances of noncompliance as well as systems of control adopted by the board to address issues identified. Life-threatening events, such as the listeria outbreak in *Marchand*, call for more frequent emergency meetings of the board and constant updates, as noted by the court. Concrete board actions, such as approval of the company's budget, can direct resources to preventive and remedial measures and fund compliance efforts.

Contacts

Steven M. Haas
shaas@HuntonAK.com

Melinda Brunger
mbrunger@HuntonAK.com

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