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'Blue Bell' Reaffirms but Does Not Expand the Boundaries of Oversight Liability

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Courtesy photo

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Plaintiffs and defendants alike may have thought they felt tremors ripple through the legal system last month when, for the first time, the Delaware Supreme Court reversed dismissal of derivative claims based on an alleged failure to monitor in *Marchand v. Barnhill*, Case No. 533, 2018, 2019 Del. LEXIS 310 (June 18, 2019), or "*Blue Bell*." Prior to the *Blue Bell* decision, the court has repeatedly recognized that claims asserting that directors are liable for allegedly failing to monitor or oversee a corporation—often referred to as *Caremark* claims—rest upon what is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," as in *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006) (quoting *In re Caremark International Derivative Litigation*, 698 A.2d 959, 967 (Del. Ch. 1996)). Now, in a unanimous decision authored by Chief Justice Leo E. Strine Jr. just days before he announced his retirement, the court has confirmed that such claims are viable when a board fails to implement any system to monitor a company's central compliance risks, see *Blue Bell*, 2019 Del. LEXIS 310, at *36-37. It can be expected that plaintiffs will prominently feature *Blue Bell* in virtually all briefs opposing dismissal of *Caremark* claims for years to come. A careful review of the *Blue Bell* decision, however, reveals that it contains nothing seismic.

Properly understood, *Blue Bell* does not lower the high bar for pleading oversight liability. In reversing dismissal, the court held, first, that the plaintiff had pleaded demand futility by alleging that a majority of the company's directors lacked independence, and, second, that the plaintiff had stated a claim for oversight liability under *Caremark*. It has been settled Delaware law for decades that "the necessary conditions predicate for oversight liability are the directors utterly failed to implement any reporting or information system or controls; or having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of the risks or problems requiring their attention," see *Stone*, 911 A.2d at 370 (applying *Caremark*). *Blue Bell* is a straightforward application of the first prong of this test. Its holding will have little impact on most motions to dismiss *Caremark* claims for at least two reasons.

First, the court's reasoning must be confined to the extraordinary facts of the *Blue Bell* case, where the board's inattention to "central compliance risks" jeopardized the viability of the company and the lives of its customers. The court emphasized that Blue Bell is a "monoline company that makes a single product—ice cream." The company's management became aware that a potentially fatal bacteria, listeria, was present in the company's ice cream production facilities. Federal and state regulators had cited multiple food safety issues at the company's facilities, and both internal reports and a report from a private third party observed that listeria was present at its facilities. In fact, Blue Bell received 10 positive tests for listeria in a single year. Nonetheless, management's reports to the board in that time period allegedly relayed positive information about sanitation and made no reference to listeria, and the board implemented no reporting controls in an effort to ensure that it would become informed of this and similar risks.

Blue Bell's board learned of this issue for the first time only after the company recalled some of its products. At that point, there had been two years of evidence that listeria was a growing problem. Even then, the board did not convene emergency meetings or require constant updates; it instead deferred to the company's management to address the issue. Within two months, the company was forced to recall all of its products. Tragically, three of its customers died from the bacteria. The company suffered a complete operational shutdown, laid off a third of its workforce, and spiraled into a liquidity crisis. In light of these striking allegations, the court reasoned that the company's directors could not have responsibly allowed themselves to remain oblivious for years to these critical risks, which implicated the core of the company's operations.

Although reversing dismissal of *Caremark* claims was an unprecedented outcome, the court's reasoning was wholly consistent with its precedent. The court had repeatedly made clear that *Caremark* liability is limited to instances of bad faith, see, e.g., *Stone*, 911 A.2d at 370, and *Blue Bell* is no exception. The court took great pains to emphasize that the board must have known that it needed to monitor the safety of Blue Bell's ice cream because that was the only product the company produced; in the court's words, "food safety was essential and mission critical." Even after the board was told that the company had to recall some of its products due to a listeria outbreak, the board failed to become actively engaged in monitoring the problem. Its failure to do so could only have been a conscious abdication of appropriate oversight duties. Moreover, the court's decision also aligns with precedent signaling that heightened scrutiny may be applied where directors are inattentive to issues that obviously imperil human safety. Thus, the circumstances alleged in *Blue Bell* are consistent with those in which Delaware courts have long suggested that *Caremark* liability may arise. Although it is predictable that plaintiffs will attempt to analogize innumerable corporate misfortunes to the near collapse of Blue Bell, nothing in the decision hints that there could be *Caremark* liability in the vast run of cases where a corporate harm will not concern a hazard that was both obvious and critical to the company's operations, or it will be clear that the board had established at least some reporting controls in an effort to become informed of such risks.

Second, although the court held that the plaintiff stated a claim under *Caremark*, it did not excuse demand based on the strength of that claim. Derivative plaintiffs are, of course, required to make a demand on the board of directors before asserting claims on a corporation's behalf, unless they satisfy the stringent burden of pleading that a demand would be futile. In many derivative cases, plaintiffs attempt to avoid the demand requirement by arguing that the potency of their claims alone disables the board from reviewing a demand properly. Delaware courts approach that theory with extreme skepticism. And rightly so: If they credited the "bootstrapping" argument that derivative claims themselves suffice to excuse demand, then demand would be excused in every case. Delaware courts have refused to nullify the demand requirement that way. Accordingly, they hold that derivative claims will excuse demand only in rare cases in which the plaintiffs plead specific allegations of fact establishing that their claims subject a majority of the board to a "substantial likelihood" of personal liability. This is among the most stringent pleading burdens in the law. Significantly, *Blue Bell* did not hold that this burden had been satisfied. Rather, it held that demand was excused for the unrelated reason that a majority of the board lacked independence. Having found that demand was futile, the court went on to consider only whether the plaintiff had stated a legally viable *Caremark* claim under a notice pleading standard. That is the lowest pleading burden. Therefore, *Blue Bell* reasoning is largely confined to cases in which demand is excused on grounds unrelated to the risk of director liability.

In sum, although *Blue Bell* promises to become part of the standard vocabulary in plaintiffs legal briefs, it does not change the law. It does not obligate directors and officers to predict and prevent all traumas companies face. It does not impose liability when companies incur injuries unrelated to their most central compliance risks. It does not require that directors' efforts to learn about critical risks will always succeed or ever succeed immediately. It does not deprive directors of the right to rely on management to address risks, nor does it require that directors or officers will invariably prevail in mitigating risks once they are identified. Rather, *Blue Bell* applies settled principles to atypical facts and stands as a reminder that directors must take reasonable steps to become informed of the most vital threats to the corporations they serve.

In the wake of the *Blue Bell* decision, it is advisable for boards to take stock of the "central compliance risks" facing their companies and assess whether they are receiving sufficient reports about those risks. It is also advisable to consider whether the corporation's minutes sufficiently document director attention to those risks. Upon notice of particularly severe problems, the board should consider whether to implement heightened reporting controls, including additional board meetings, in an effort to ensure that it is aware of management's progress in resolving the issue. It is not, however, the time to assume that the floodgates of *Caremark* liability have swung open.

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