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DELAWARE SUPREME COURT REVISITS OVERSIGHT LIABILITY

To Our Clients and Friends:

In a recent decision applying the famous *Caremark* doctrine, the Delaware Supreme Court confirmed several important legal principles that we expect will play a central role in the future of derivative litigation and that serve as important reminders for boards of directors in performing their oversight responsibilities. In particular, the Delaware Supreme Court held that a claim for breach of the duty of loyalty is stated where the allegations plead that "a board has undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business operation."[1]

Although the case addressed extreme facts that will have no application to most mature corporations, the plaintiffs' bar can be expected to attempt to weaponize the decision. With all the benefits that hindsight provides, derivative plaintiffs will more frequently contend that a board lacked procedures to monitor "central compliance risks" that were "essential and mission critical."[2] The Supreme Court's decision reinforces that directors need to implement controls that enable them to monitor the most serious sources of risk, and may even caution in favor of a special discussion each year around critical risks.

The Decision

Marchand involved problems at Blue Bell Creameries USA, Inc., "a monoline company that makes a single product—ice cream."[3] After several years of food-safety issues known by management, the company suffered a *listeria* outbreak. This outbreak led to a product recall, a complete operational shutdown, the layoff of one-third of employees, and three deaths.[4] The operational shutdown, in turn, caused the company to accept a dilutive investment to meet its liquidity needs.[5] After obtaining books and records, a stockholder sued derivatively alleging breach of fiduciary duties under *Caremark*.[6] That theory requires sufficiently pleading that "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."[7]

The plaintiff, though, chose not to make a demand on the board before suing on behalf of the company, so he was subject to the burden of pleading that making a demand would have been futile. In an effort to do so, he tried to allege that a majority of the board was not independent because it could not act impartially in considering a demand and that the directors also faced liability under *Caremark*. The Delaware Court of Chancery rejected both arguments, holding that the plaintiff came up one director short on his independence theory and that the plaintiff failed to plead liability under *Caremark*.[8] The Delaware Supreme Court reversed both holdings.[9]

On independence, Chief Justice Strine continued his instruction from *Delaware County Employees Retirement Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015) and *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016) that Delaware law "cannot ignore the social nature of humans or that they are motivated by things other than money, such as love, friendship, and collegiality."[10] "[D]eep and long-standing friendships are meaningful to human beings," the Chief Justice reasoned, and "any realistic consideration of the question of independence must give weight to these important relationships and their natural effect on the ability of parties to act impartially towards each other."[11] The director at issue, although recently retired from his role as CFO at the company, owed his "successful career" of 28 years at the company to the family of the CEO whom the director would be asked to sue.[12] And that family "spearheaded" an effort to donate to a local college that resulted in the college naming a new facility after the director.[13] These facts "support[ed] a pleading-stage inference" that the director could not act independently.[14]

This was so despite the director's previously voting against the CEO on whether to split the company's CEO and Chairman position. Although the Court of Chancery reasoned that this militated against holding that the director was not independent, the Delaware Supreme Court held it was irrelevant to the demand futility analysis.[15] Voting to sue someone, the Supreme Court explained, is "materially different" than voting on corporate-governance issues.[16] The Supreme Court thus held that the number of directors incapable of acting impartially was sufficient to excuse demand.

On *Caremark* liability, the Court focused on the first prong of the *Caremark* test: whether the board had made any effort to implement a reporting system. It explained that a director "must make a good faith effort" to oversee the company's operations. "Fail[ing] to make that effort constitutes a breach of the duty of loyalty"[17] and can expose a director to liability. To meet this standard, the board must "try"[18] "to put in place a reasonable system of monitoring and reporting about the corporation's *central compliance risks*."[19]

For Blue Bell, food safety was "essential and mission critical"[20] and "the obviously most central consumer safety and legal compliance issue facing the company."[21] Despite its importance, the complaint contained sufficient facts to infer that no system of board-level compliance monitoring and reporting over food safety existed at the company. For example:

- "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 [we]re devoid of any suggestion that there was any regular discussion of food safety issues."[22]

These shortcomings convinced the Delaware Supreme Court that the plaintiff had pleaded sufficient allegations that Blue Bell's "board ha[d] undertaken no efforts to make sure it [wa]s informed of a compliance issue intrinsically critical to the company's business operation." *Id.* at 33. So the Court could infer that the board "ha[d] not made the good faith effort that *Caremark* requires."[23]

That management "regularly reported" to the board on "operational issues" was insufficient to demonstrate that the board had made a good faith effort to put in place a reasonable system of monitoring and reporting about Blue Bell's central compliance risks.[24] So, too, was "the fact that Blue Bell nominally complied with FDA regulations."[25] Neither of these facts showed that "the *board* implemented a system to monitor food safety at *the board level*."[26] In light of these facts, the Supreme Court held that the plaintiff met his "onerous pleading burden" and was entitled to discovery to prove out his *Caremark* claim.[27]

Key Takeaways

- Independence: Close Personal Ties Increase Litigation Risk
    - Directors should be aware that the greater the level of close personal or business relationships amongst themselves, management, and even each other's families, the greater risk they face of being held incapable of exercising their business judgment in a demand futility analysis, even in circumstances where they have plainly demonstrated independent or dissenting judgment on corporate-governance matters.
- *Caremark*
    - Increased Litigation Risk over Compliance Efforts
        - *Derivative Litigation*. Although *Caremark* claims will remain "the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,"[28] we expect an increase in attempted derivative litigation over a purported lack of board-level monitoring systems for specific risks as plaintiffs try to shoehorn as many standard business and non-business risks as possible into *Marchand*'s "essential and mission critical" risk category. Whereas to date many *Caremark* claims have focused on the second prong of the standard—alleging that a board consciously failed to monitor or oversee the operation of its reporting system or controls and by ignoring red flags disabled themselves from being informed of risks or problems requiring their attention—*Marchand* likely will focus plaintiffs on the first prong: whether in particular areas a board failed to implement *any* reporting or information system or controls.
        - The plaintiffs' bar is bound to focus on the full array of corporate risks, including many that are not correctly characterized as "central compliance risks" for most companies. These areas could range from risks disclosed in the company's SEC filings to cultural

issues, like harassment or bullying, and more broader environmental, social, and governance ("ESG") issues.

- *Books and Records Litigation*. Similarly, we expect a rise in Section 220 books and records demands seeking to investigate a board's *specific* oversight of central compliance risks.

- Assessing Central Compliance Risks

    - *Marchand* does not change the core principle that a company's board of directors is responsible for seeing that the company has systems in place to provide the board with information that is sufficient to allow directors to perform their oversight responsibilities. This includes information about major risks facing the company.

    - The Delaware Supreme Court emphasized in *Marchand* that these systems can be "context- and industry-specific approaches tailored to . . . companies' business and resources."[29] Accordingly, boards have wide latitude in designing systems that work for them. In light of this, boards should be comfortable that they understand the "central compliance risks" facing their companies. They should satisfy themselves that they are receiving, on an appropriate schedule, reports from management and elsewhere on these central risks and what management is doing to manage those risks.

    - In recent years, many boards have devoted significant time to thinking about how best to allocate responsibility for risk oversight at the board level. Boards should be comfortable that there is adequate coverage, among the full board and its committees, of the major compliance and other risks facing the corporation, and that the full board is receiving appropriate reports from responsible committees, as well as from management. They also should periodically evaluate the most effective methods for monitoring "essential and mission critical" risk to their companies, even where these risks do not relate directly to operational issues, and whether the current committee structure, charters, and meeting schedules are appropriate. These efforts, reports, and discussions should be documented.

    - Boards should establish systems so that management provides them with an adequate picture of compliance risks. In *Marchand*, although management received many reports about food-safety issues, "this information never made its way to the board."[30]

    - Boards should remain mindful of the second prong in *Caremark* by overseeing the company's response when they are informed of risks or problems requiring their attention. When reporting systems or other developments demonstrate that risks are becoming manifest, directors should assess whether a need exists to implement a heightened system of monitoring, such as setting additional meetings and requiring additional reports from management about the steps the company is taking to address the risk. Boards should hesitate to leave the response entirely to management.

- Documenting the Board's Work
  - Minutes of board meetings, and board materials, should not just reflect the "good news." Instead, they should demonstrate that the board received appropriate information about issues and challenges facing the company, and that the board spent time discussing those issues and challenges. The goal should be to create a balanced record demonstrating diligent oversight by the board, while recognizing that those minutes could be produced in litigation.

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[1] *Marchand v. Barnhill*, No. 533, 2018, slip op. at 33 (Del. June 18, 2019).

[2] *Id.* at 36.

[3] *Id.* at 5.

[4] *Id.* at 1.

[5] *Id.*

[6] *Id.* at 19.

[7] *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[8] *Marchand*, No. 533, 2018, slip op. at 20-23.

[9] *Id.* at 3.

[10] *Id.* at 25.

[11] *Id.* at 28.

[12] *Id.* at 26.

[13] *Id.*

[14] *Id.* at 29.

[15] *Id.* at 27.

[16] *Id.*

[17] *Id.* at 37.

[18] *Id.* at 30.

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

[20] *Id.*

[21] *Id.* at 37.

[22] *Id.* at 32-33.

[23] *Id.*

[24] *Id.* at 35-36.

[25] *Id.* at 34.

[26] *Id.*

[27] *Id.* at 37.

[28] *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006).

[29] *Marchand*, No. 533, 2018, slip op. at 30.

[30] *Id.* at 12.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Securities Litigation or Securities Regulation and Corporate Governance practice groups, or the authors in Washington, D.C.:

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