Corporate Litigation:

Corporate Directors' Duty of Oversight

JOSEPH M. MCLAUGHLIN AND SHANNON K. MCGOVERN*

SIMPSON THACHER & BARTLETT LLP

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Stockholder plaintiffs seeking to assert a non-exculpated breach of fiduciary duty claim against corporate directors arising from adverse company news frequently allege that the directors breached their duty of loyalty by failing to exercise appropriate oversight over company activities. The hallmark of the claim known under Delaware law as a *Caremark* claim is bad faith; director liability requires proof that the directors knowingly (1) failed to implement any board-level reporting or information system or controls; or (2) having implemented such a system or controls, consciously failed to monitor or oversee its operation. While Delaware courts have repeatedly characterized the claim as possibly the most difficult claim in corporate law to establish, a recent Delaware Supreme Court decision reversing dismissal of a *Caremark* claim reminds practitioners that courts will scrutinize board members' close personal relationships with management when analyzing demand futility and that directors' duty to monitor does have substance. In *Marchand v. Barnhill*, — A.3d —-, 2019 WL 2509617 (Del. June 18, 2019), the court emphasized *Caremark*'s "bottom-line requirement" that a board "make a good faith effort—i.e., try—to put in place a reasonable system of board-level monitoring and reporting." While only a motion to dismiss decision, *Marchand* provides practical guidance on how boards may discharge their risk oversight duties.

Background

Under *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996), directors must make a good faith effort to oversee the company's operations, including legal compliance and financial performance. A typical *Caremark* claim is brought by a stockholder as a proposed derivative claim, alleging that the board knowingly or recklessly caused or allowed the company to violate applicable law, resulting in money damages to the company. As developed in decisions amplifying then-Chancellor Allen's *Caremark* decision, the bad faith necessary for liability is established when directors either (1) completely fail to implement any reporting or information system or controls, or (2) having implemented such measures, consciously fail to monitor or oversee the company's operations, thereby knowingly "disabling themselves from being informed of risks or problems requiring their attention." *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). Under either theory, the "imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." Id.

****Joseph M. McLaughlin*** *is a Partner and* ***Shannon K. McGovern*** *is an Associate at Simpson Thacher & Bartlett LLP.*

Central to *Caremark*'s formulation of the standard for oversight liability is the obligation to act in good faith, which is part of the duty of loyalty. The requirement to demonstrate bad faith to establish liability under an oversight theory recognizes standard corporate charter provisions exculpating directors from liability for breaches of the duty of care. In short, to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it to ensure it works by getting information to the board about company operations, legal compliance and financial performance.

'Marchand'

In *Marchand*, a stockholder of Blue Bell Creameries sued the ice cream manufacturer's management and board following a fatal bacterial outbreak traced to its manufacturing plants. While the complaint alleged that management was aware that listeria was detected in its plants throughout 2013 to 2015, the board was not informed of the growing problem. In fact, board minutes from the period, obtained through a §220 demand for inspection of books and records, contained a single reference to board-level discussion of food safety issues, in connection with a 2014 report to the board about the result of a third-party sanitation audit. According to the plaintiff, the board was first informed of the listeria problem only after Blue Bell issued an initial product recall in February 2015. Ultimately, Blue Bell was forced to issue a full product recall, in April 2015, and three consumers died as a result of complications from listeria infection. The complaint alleged that the board was liable under a *Caremark* theory because it had instituted no board-level committee, process or protocol for overseeing food safety, nor did it discuss food safety at board meetings. The Court of Chancery dismissed the complaint, holding the plaintiff had failed to plead demand futility—i.e., sufficient facts to cast doubt on the disinterestedness of a majority of the Blue Bell board—and failed to state a *Caremark* claim against the board. In so holding, the Court of Chancery concluded that the complaint did not challenge the existence of monitoring and reporting controls, but their effectiveness.

The Supreme Court reversed, disagreeing with the Court of Chancery on the question of Board independence with respect to a board member's "deep and longstanding friendships" with the Kruse family, which has managed Blue Bell for decades. It rejected the Court of Chancery's reasoning that the board member's decision to vote differently than CEO and Chairman Paul Kruse with respect to a proposal to split the CEO and Chairman positions evidenced independence, concluding "the decision whether to sue someone is materially different and more important than the decision whether to part company with that person on a vote about corporate governance." 2019 WL 2509617, at *11.

The Supreme Court then reversed the dismissal of the *Caremark* claims against the directors, although emphasizing that such claims "are difficult to plead and ultimately prove out." Id. Crucial to the Supreme Court's determination that the plaintiff had met Caremark's "tough standard" was the complaint's allegations that the board has "undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business operation." Id. at *13. Particularized allegations concerning the failure of Blue Bell's board to implement and oversee monitoring of food safety apart from its generalized oversight of company operations supported an inference of bad faith because product safety is integral to its business. This failure did not amount to an allegation that board-level compliance controls were ineffective, the court concluded, but that they were wholly absent.

Last week, Chancellor Andre Bouchard applied *Marchand* in *Rojas v. Ellison*, 2019 WL 3408812 (Del. Ch. Ct. July 29, 2019), and reconfirmed the difficulty of alleging a failure-of-oversight claims when a board-level reporting system is in place. The plaintiff in *Rojas*asserted a *Caremark* challenge to J.C. Penney's compliance with price comparison advertising policies and practices in the wake of a consumer class action settlement.

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The decision invoked *Marchand*'s teaching that under *Caremark* "the board must make a good faith effort—i.e., try—to put in a place a reasonable board-level system of monitoring and reporting." Id. at *8. The stockholder plaintiff alleged that pre-suit demand was excused because a majority of the department store company's board faced a substantial likelihood of personal liability with respect to the complaint's *Caremark* claims. The plaintiff, however, failed to allege facts sufficient to support claims under either *Caremark* standard, as (1) the complaint itself indicated that the board's audit committee oversaw legal and regulatory compliance and received updates on the class action litigation, including its settlement, and (2) plaintiff had not alleged that the board consciously failed to monitor the company's pricing compliance through these mechanisms. With respect to the second prong, plaintiff was unable to allege that the directors knew or should have known that J.C. Penney was violating the law, as the court agreed with defendants that the existence and amount of the consumer class action settlement was not a "red flag" indicating noncompliance.

Conclusion

Marchand carefully limited its holding that the complaint before it stated a *Caremark* claim to the stark facts of the case, including the severity of the underlying food safety lapses, their impact on the company's business, and the dearth of reports to the board on the subject matter of the compliance problem. As last week's *Rojas* decision reflects, *Marchand* is unlikely to be interpreted as a game-changer. Both decisions emphasized that the *Caremark* standard does not examine the effectiveness of a board-level compliance and reporting system after-the-fact. Rather, it examines whether a complaint pleads facts supporting a reasonable inference that the board did not make good faith attempts to put a board-level system of monitoring and reporting in place and employ it in a manner calculated to bring significant potential problems to the board's attention. (The court suggested at least quarterly or biannual reports to the board on important matters is good practice.) *Marchand* also took pains to note that *Caremark* allows for flexible approaches to the design and implementation of risk oversight systems which take into account the company's business, knowable risks and resources. If directors have a good faith board-level reporting system in place at the company to monitor its compliance with laws and regulations, it remains exceedingly challenging for a stockholder plaintiff to adequately allege a *Caremark* claim.