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July 1, 2019

Legal Update

Delaware Decision Breathes New Life Into Bad Faith Claims Against Directors: Practical Advice After *Marchand v. Barnhill* Allows Bad Faith Claim Based on Failure to Monitor Central Compliance Risks

In the recent case of *Marchand v. Barnhill*,[1] the Delaware Supreme Court reversed the dismissal of a claim that the directors of Blue Bell Creameries USA, Inc. ("Blue Bell") had breached their duty of loyalty under *Caremark*[2] and *Stone*[3] through a lack of oversight.[4] In reversing the Chancery Court's decision on the *Caremark* claim, the Supreme Court held that the plaintiff had pled facts supporting a reasonable inference that the Blue Bell directors "consciously failed 'to attempt to assure a reasonable information and reporting system existed'" and that, as a result, the duty of loyalty was breached. Under Delaware law, a director can be *personally* liable for breaches of the duty of loyalty.[5]

Background of *Marchand V. Barnhill*

Blue Bell has produced and distributed ice cream and other related products since 1907. Because it manufactures food, Blue Bell is heavily regulated by the Food and Drug Administration ("FDA"), which requires, among other things, that operations be conducted "with adequate sanitation principles" and, in line with that obligation, requires the "[implementation of] a written food safety plan." In addition to being subject to federal regulation, Blue Bell was subject to state regulation in three states that had each issued rules and regulations regarding the proper handling and production of food. In light of the nature of Blue Bell's business and the regulatory framework within which Blue Bell operated, the Supreme Court found that, in Blue Bell's case, "food safety was essential and mission critical" and "the obviously most central consumer safety and legal compliance issue facing the company."

In early 2015, Blue Bell suffered a listeria outbreak which ultimately resulted in the deaths of three people. Following the outbreak, Blue Bell was forced to recall all of its products, shut down production at all of its plants and lay off over one third of its workforce. After its operations were halted, Blue Bell faced a liquidity crisis and was forced to seek equity and debt financing to sustain its operations.

In the years leading up to the listeria outbreak in 2015, there were several warning signs and issues with food safety compliance that management became aware of, including

multiple failed listeria screening tests and various failures to maintain equipment and manufacturing facilities in compliance with applicable regulatory standards. The complaint alleges that none of these were reported to the board.

The court noted that, while Blue Bell did have sanitation policies and procedures in place at all relevant times, the board did not have any committees or reporting systems specifically designed to keep it informed of food safety concerns and instead relied on discretionary updates from management regarding those matters.

A Blue Bell stockholder requested Blue Bell's books and records through a request under Section 220 of the DGCL. Based on information gleaned from those books and records, the stockholder brought a derivative action against members of Blue Bell's management and board asserting that, among other things, the board had violated its duty of loyalty under *Caremark* by failing to implement a reporting system that would allow it to inform itself about Blue Bell's food safety compliance. The Chancery Court dismissed that claim on the basis that Blue Bell had a *Caremark* compliant monitoring system in place because Blue Bell had implemented operational policies and procedures in compliance with FDA regulations, Blue Bell was subject to monitoring by regulators for contamination, and Blue Bell's management consistently reported to the board about the company's operations.

Legal Background

CAREMARK

In *Caremark*, the stockholders of Caremark International, Inc. brought a derivative action alleging that the directors breached their duty of care by failing to put in place adequate internal control systems. The plaintiff alleged that the board's lack of oversight allowed the company's employees to commit criminal offenses, resulting in substantial fines and civil penalties to the company and other amounts payable by the company amounting to over $250 million.

The Chancery Court held that the board has a duty to "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." If the directors systematically fail to exercise such oversight—such as where the board utterly fails to implement such a system—then the board would be deemed to have not acted in good faith, and such failure may expose a director to liability for breach of that duty.

STONE

In *Stone*, the plaintiffs alleged the directors breached their duty of oversight because the corporation failed to comply with the Bank Secrecy Act and anti-money-laundering regulations, which led to approximately $50 million in penalties to the corporation. The directors had put in place programs and procedures for compliance, including a dedicated compliance officer, a compliance department, a corporate security department and a suspicious activity oversight committee.

The *Stone* court held that the plaintiffs in that case failed to allege particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities and accordingly the derivative action was dismissed for failure to make a demand on the board. Referencing *Caremark*, the *Stone* court indicated that oversight liability is established where "(a) the directors utterly failed to implement any reporting or information system or controls, or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." The *Stone* court also

established that directors' failure to exercise *Caremark* oversight was a breach of the duty of loyalty since proving a *Caremark* violation required a showing of bad faith conduct by directors.

In *Stone*, the court reasoned that the company had established a reasonable information and reporting system and had set up various departments and committees to oversee its compliance with applicable regulations, which enabled the board to periodically monitor that compliance. The *Stone* court indicated that, while it was clear with hindsight that employees failed to perform properly, there were no red flags to notify the board of any wrongdoing. And although there ultimately may have been failures by employees to report deficiencies to the board, the *Stone* court found no basis for an oversight claim seeking to hold the directors personally liable for those failures by the employees.

Marchand Decision

While the Supreme Court in *Marchand* noted that a *Caremark* claim is "difficult to plead and ultimately to prove out," the court nonetheless determined that the plaintiff's complaint alleged facts supporting a reasonable inference that the Blue Bell directors failed to make a good faith effort to establish a reasonable system of oversight of Blue Bell's central compliance risks.

In its rationale, the court cited *Stone* and indicated that failing to make a good faith effort to oversee the company's operations breaches the duty of loyalty and can expose a director to liability. The court stated that, under *Caremark*, "the board must make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting." The court noted that "[Delaware] case law gives deference to boards and has dismissed *Caremark* cases even when illegal or harmful company activities escaped detection" and stated that, in order to prevail on a *Caremark* claim, the plaintiff must establish that the board made no effort to put in place a board-level compliance system. Central to the court's analysis in *Marchand* was whether the board had made good faith efforts to put in place a board-level system of monitoring and reporting.

Noting that it was "intrinsically critical" to Blue Bell's operations that its ice cream be safe to eat, the court identified the following allegations as supporting a fair inference that "no system of board-level compliance monitoring and reporting existed at Blue Bell":

- No board committee existed to address food safety;
- There were no regular processes or protocols that required management to keep the board apprised of food safety compliance practices, risks or reports;
- There was no schedule for the board to consider key food safety risks on a regular basis (such as quarterly or biannually);
- During a key period leading up to the deaths of three customers, management received reports that described material food safety issues, and the board minutes of the relevant period revealed no evidence that these reports or issues were disclosed to the board;
- The board was given certain favorable information about food safety by management but was not given important reports that identified food safety issues that could adversely impact the company; and
- The board meetings did not include regular discussion of food safety issues.

Blue Bell's directors claimed that sufficient reporting systems were in place because Blue Bell had to meet FDA and state regulatory requirements for food safety, had internal policies and procedures on food safety matters, was subject to government inspection and underwent audits from time to time. In response to these claims, the court noted that "the fact that Blue Bell nominally complied with FDA regulations does not imply that the *board* implemented a system to monitor food safety *at*

the board level" (emphasis in original). The directors also noted that management reported to the board regularly on "operational issues." But, again, the court stressed that discretionary reporting by management regarding operations was not a board-level reporting system and did not, in and of itself, satisfy the *Caremark* standard.

Practice Points

A key principle emphasized by the *Marchand* decision is that the required monitoring and reporting system must be a board-level system. Delegating to management the responsibility for the design and operation of the system, without any board-level involvement, is insufficient. Accordingly, a board should consider what steps it should take to make certain this board-level system is in place. Among the steps that could be considered are the following:

1. **Prioritizing Principal Risks to Be Monitored and Overseen.** *Caremark*, *Stone* and *Marchand* call for the directors to "make a good faith effort to oversee the company's operations," and, in particular, the board must "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." This raises the question of what is "appropriate information" for a particular company. The court in *Marchand* noted that food safety was "one of the most central issues at the company." The importance of food safety and the potential for very significant harm to consumers and to the company was given significant weight by the court in determining the importance and nature of the required information and reporting systems for the company. This suggests that it is appropriate for a board to consider what risks should be prioritized for monitoring and oversight. Clearly, information regarding food safety is appropriate for an ice cream manufacturer or other food company. But what other risks of an ice cream manufacturer will the board want to prioritize and obtain "appropriate information" about? Given the variety of risks facing a company and given the range of probability, nature and magnitude of those risks, deciding what risks merit a prioritized level of monitoring and oversight will call for careful consideration and judgment. Examples can include risks relating to cybersecurity, violations of laws, consumer safety, employee safety, environmental damage, natural disasters and a variety of other risks (many of which may be identified in the risk factors listed in the company's 10-K). Periodic and regular reassessments of such risks as the company's business changes and other developments arise would also be useful to ensure that the board continues to focus on the company's "central issues." While prioritizing particular risks does not mean a board can ignore other risks, it does potentially help a board and management to thoughtfully design the information and reporting systems called for by *Caremark*.
2. **Board Committee.** A possible tool available to a board to address its monitoring and oversight responsibilities is the use of an existing, or the creation of a new, board committee to address an area of risk. Audit committees are sometimes given monitoring and oversight responsibilities for certain areas not traditionally under the purview of audit committees (e.g., cybersecurity). But the agendas and responsibilities of audit committees are already substantial, so a board may want to give responsibility to a committee with a focused mandate (e.g., a technology committee) or a committee

with a more general mandate (e.g., a risk committee, similar to those in place in a number of financial institutions). In any event, a board considering *Marchand* may choose to take this meaningful step of giving a board committee a significant role in assuring that the board is carrying out its *Caremark* duties.

3. **Board Information and Deliberations.** *Marchand* strongly signals the importance of a board receiving appropriate information regarding risks and considering that information. Prioritized risk areas should be addressed periodically at board meetings, with relevant reports being provided and appropriate discussions taking place. In addition to such regularly calendared agenda items, the board should make certain that management is responsible for promptly reporting to the board material developments relating to any of the company's risks so that material matters relating to prioritized as well as non-prioritized risks are brought to the board's attention in a timely manner.

4. **Outside Advisors.** To supplement management reports and guidance, the board may want to consider obtaining input from outside technical, legal or other advisors or consultants regarding key risk areas of the company and the adequacy of systems in place to monitor and address these risks. Outside advisors or consultants may have insights regarding the experiences of other similarly situated companies, best practices and other matters that could increase the board's confidence that risk areas are being adequately identified, considered and addressed.

5. **Minutes and Other Records.** In addition to the board doing the right things, it is important that the company create a record that those things have in fact been done by the board. The court in *Marchand* noted the absence in board minutes of any mention of board consideration of food safety matters. To enable the company's counsel to successfully and efficiently defend against any eventual claims regarding an allegedly under-addressed risk (and indeed to reduce the likelihood of any such claims being made), the company should make certain that there are written policies and procedures designed to ensure that the board is discharging its *Caremark* duties and that board and committee minutes adequately memorialize the topics addressed and tasks performed by the board and its committees in their meetings.

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Endnotes

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

[2] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (Allen, C.).

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

[4] In *Marchand*, the Delaware Supreme Court also reversed the Chancery Court's holding that the plaintiff's demand was not excused because the plaintiff had not pled facts that raised a reasonable doubt that Blue Bell directors holding a majority of the board votes would be able to impartially consider claims against management. This Legal Update does not address that holding.

[5] While Section 102(b)(7) of the Delaware General Corporation Law (the "DGCL") permits a corporation to include in its certificate of incorporation a provision eliminating liability of a director for breach of fiduciary duty, the statute expressly excludes from such exculpation liability for breach of a director's duty of loyalty to the corporation or its stockholders or for acts or omissions not in good faith. In addition, Section 145 of the DGCL requires that in order for a director to receive indemnification from the corporation, the director, among other things, must have acted in good faith.

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