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DIRECTOR LIABILITY

Marchand v. Barnhill: Addressing and Monitoring Corporate Risk

Stockholder plaintiffs generally face a high burden in surviving a motion to dismiss on so-called Caremark *claims challenging the board's compliance with its duty of oversight. A recent Delaware Supreme Court opinion illustrates the circumstances in which a plaintiff making a* Caremark *claim may withstand a motion to dismiss. It also provides guidance on implementing and monitoring systems and controls to demonstrate compliance with oversight duties.*

By John Mark Zeberkiewicz and Robert B. Greco

In *Marchand v. Barnhill*, the Delaware Supreme Court provides substantial guidance regarding the contours of the board of directors' duty of oversight.[1] Perhaps equally important, the opinion highlights the need to ensure that the board's deliberations over, and actions in response to, "the corporation's operational viability, legal compliance, and financial performance" are documented adequately to evidence the directors' satisfaction of this duty.[2] The Supreme Court's decision also examines demand futility issues and is the latest in a series of recent opinions in which the Delaware courts have focused on long-term social relationships in questioning whether a director is sufficiently independent to make the decision whether to bring suit against individual defendants.

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Background

The claims in *Marchand* stemmed from a *listeria* outbreak that struck ice cream manufacturer Blue Bell Creameries USA, Inc. (Blue Bell) in 2015. The outbreak, from which three people were found to have died, resulted in a recall of all of Blue Bell's products, facility shutdowns, and employee layoffs. Those ensuing events triggered a liquidity crisis, following which Blue Bell accepted a financing transaction in which a private equity fund provided it with a $125 million credit facility and purchased a $100 million warrant to acquire a significant stake in Blue Bell. In connection with that investment, the fund obtained the right to appoint one director, albeit one who was entitled to cast one-third of the board's voting power.

In the aftermath of the *listeria* outbreak, the plaintiff, a Blue Bell stockholder, initiated a demand for books and records under Section 220 of the Delaware General Corporation Law (DGCL) to investigate claims of potential breach of fiduciary duty. The plaintiff subsequently commenced a derivative action against members of Blue Bell's management as well as its board, alleging that management had failed to respond appropriately to "red and yellow flags about growing food safety issues"[3] and asserting *Caremark*-based claims[4] for breach of the duty of loyalty against the board for failing to implement an adequate reporting system and failing to inform itself about the food-safety compliance matters.

The Court of Chancery's Dismissal

The Court of Chancery dismissed the claims on the basis that the plaintiff had failed to plead demand futility under Rule 23.1.[5] With respect to the claims against management, the Court of Chancery found that the plaintiff had failed to plead particularized facts sufficient to raise a doubt that a majority in voting power of Blue Bell's board could have considered impartially the pre-suit demand. In essence, the Court of Chancery found that, of the 15 votes the directors were collectively entitled to cast, the plaintiff was only able to raise sufficient doubts with respect to directors casting seven.[6] The Court of Chancery also rejected the plaintiff's *Caremark* claims, finding that the complaint contained no allegations that Blue Bell had failed to implement adequate monitoring and reporting systems required by applicable law or regulations—or that it had been cited for any failure. Instead, relying on documents incorporated by reference in the plaintiff's complaint, the Court of Chancery determined that Blue Bell had taken some steps to address operations and reporting. The Court of Chancery found that members of management had furnished the board regular reports regarding Blue Bell's operations, including with respect to facility audits. In sum, the Court of Chancery found that the plaintiff had attacked the *effectiveness* of the board's monitoring and reporting controls in particular instances, not the *existence* of monitoring and reporting controls. On that basis, the Court of Chancery dismissed the *Caremark* claims.

The Supreme Court's Reversal

Reviewing the matter *de novo*, the Supreme Court reversed the Court of Chancery on both fronts. First, the Supreme Court found that the Court of Chancery had erred in finding that directors representing a majority in voting power of the board were independent for purposes of demand futility at the pleading stage. On appeal, the plaintiff challenged the independence of two of the directors that the Court of Chancery had determined to be independent. Following a theme developed in recent cases, the Court made clear that it will scrutinize long-term social relationships in determining director independence in this context.[7] As the Court stated,

> [w]hen it comes to life's more intimate relationships concerning friendship and family, our law cannot "ignore the social nature of humans' or that they are motivated by things other than money, such as 'love, friendship, and collegiality."[8]

Applying that level of scrutiny, the Court found that there was reason to doubt the impartiality of one of the two directors in question.

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Addressing the lower court's analysis on demand futility, after noting that the pleading standard is balanced—requiring the plaintiff to plead facts with particularity but also requiring the Court to draw all reasonable inferences in favor of the plaintiff—the Court found that the plaintiff had pled claims supporting a reasonable inference "that there are very warm and thick personal ties of respect, loyalty, and affection" between the director in question and members of the family of the Chief Executive Officer (CEO), whose conduct was the subject of the plaintiff's complaint.[9] Among other things, the Court found that the director's professional success was due in part to the opportunities and mentoring afforded to him by members of the CEO's family, which ultimately led to the director becoming Blue Bell's chief financial officer (a position from which he had retired by the time of the litigation). In addition, the Court found that members of the CEO's family had led a charitable campaign to raise funds for a local college, resulting in the director having a facility at the college named in his honor. Those ties, according to the Court, were sufficient to raise a reasonable doubt as to the director's ability to sue the CEO.

The Court noted that the lower court's finding that the director was independent was driven largely by the director's previous vote to split the positions of CEO, President and Chairman of the Board (each of which was then held by Blue Bell's current CEO) against the wishes of the CEO, but it was not equally persuaded by that evidence. The Supreme Court found that the director's vote on that question did not, in and of itself, demonstrate that he was independent for purposes of demand futility. Rather, the Supreme Court explained that

> 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, and our law's precedent recognizes that the nature of the decision at issue must be considered in determining whether a director is independent.[10]

Second, as to the *Caremark* claim, the Court found that a plaintiff must make a showing of bad faith, which, in this context, involves a showing that the directors completely failed to implement a reporting or information system or controls or, having implemented such a system or controls, consciously failed to monitor or oversee its operations. Noting that directors generally have wide latitude in the design of such systems and controls, the Court nevertheless stated that directors' oversight obligations do impose on them the obligation to "make a good faith effort—*i.e.*, try—to put in place a reasonable board-level system of monitoring and reporting."[11] The Court's focus, accordingly, was whether the plaintiff had made pleading-stage allegations that Blue Bell's board had made no effort to establish a board-level system of monitoring and reporting. The Court found that the plaintiff had met its burden.

The Court's conclusion was based on, among other things, its findings that Blue Bell did not have a committee of the board focused on food safety; that no regular processes or protocols existed that required management to update the board on food safety issues; that there was no regular schedule for the Board to consider key safety food risks; that, in the lead-up to the *listeria* outbreak, during a time in which the Court found there were red and yellow food safety flags being raised, there was no mention in the Board minutes of any such concerns (and the Court found the Board had received a different picture regarding food safety); and that the minutes generally did not reflect a discussion of food safety matters.

Directors' oversight obligations do impose on them the obligation to "make a good faith effort to put in place a reasonable board-level system of monitoring and reporting."

In reaching its conclusion on the *Caremark* claim, the Court rejected the defendants' argument that Blue Bell's board had met its oversight obligations by virtue of the fact that Blue Bell was required to comply with Food and Drug Administration (FDA) and state regulatory requirements, that it had prepared and disseminated employee manuals relating to food safety, and that its facilities were subject to regular governmental inspections. That Blue Bell complied with applicable law, the Court found, did not "foreclose any pleading-stage inference that the directors' lack of attentiveness rose to the level of bad faith indifference required to state a *Caremark* claim."[12] The Court also rejected the defendants' argument that management had provided regular reports on operational matters. The Court noted that, if a defense based on a record of general discussions regarding operations were sufficient to defeat a *Caremark* claim on a motion to dismiss, "*Caremark* would be a chimera."[13] In the case of Blue Bell, whose principal line of business was producing ice cream, "food safety was essential and mission critical."[14]

Takeaways

The Supreme Court's opinion in *Marchand* offers several important takeaways for practitioners. First, in line with other recent decisions of the Delaware Supreme Court, the *Marchand* opinion demonstrates that the Delaware courts closely and holistically will examine the question of director independence in the demand-futility context. As the Court again emphasized, the question of whether to sue someone is not a decision that is taken lightly—and that personal ties that might not call into question a director's independence in other contexts will be given close scrutiny in the demand-futility context.

In light of the Court's recent opinions on the topic, corporations and practitioners, when considering board nominees, assessing which directors should be appointed to specific committees, or in preparing for litigation, should ask probing questions to assess director independence with an eye toward determining whether any director has ties of friendship or other relationships, whether or not economic, that might call into question his or her independence. The Court's decision also indicates that, where the certificate of incorporation vests one or more directors with more or less than one vote pursuant to Section 141(d) of the DGCL, the demand-futility analysis examines the voting power of the independent directors rather than the number of independent directors.[15]

With respect to the duty of oversight, the Court's opinion makes clear that, while the board has significant latitude in the design of systems of information and reporting and controls, in order to withstand a *Caremark* claim, it must be able to demonstrate that it has made a good faith effort—or, to paraphrase the Court, it must have at least tried—to have put in place systems and controls that will enable it to inform itself as to key risks. The Court's opinion recognizes that different businesses will face different risks, and accordingly does not make any one-size-fits-all pronouncements. Nevertheless, the opinion indicates that, depending on the company's market and industry, there are some risks as to which the board should have systems and controls in place. Where a particular market or industry faces specific or unique risks, *Marchand* indicates, among other things, that the existence of a committee of the board focused on those risks, or the regular appearance of an assessment of those risks on the board's agenda (*e.g.*, quarterly, bi-annually), may help to demonstrate the board's due care in monitoring those risks. It therefore may be advisable for large private corporations to establish an audit or compliance committee of the board even if they are not required to do so by applicable law.

The minutes should be drafted with sufficient detail to demonstrate that the board had received reports with respect to matters of concern.

While there is by no means a single "right way" to draft minutes, the *Marchand* opinion suggests that short-form minutes that cryptically or elliptically characterize board discussions on key aspects of risk may not be sufficient to establish that the board satisfied its oversight duties for purposes of overcoming a *Caremark* claim on a motion to dismiss. Although minutes should not be a transcript of the meeting, the *Marchand* opinion suggests that, as it relates to the board's deliberations over key areas of risk, the minutes should be drafted with sufficient detail to demonstrate that the board had received reports with respect to matters of concern and had taken actions or steps to respond as and when appropriate. Vague references to the board's deliberations as to "operational matters," based on the *Marchand* opinion, likely will not, of themselves, constitute sufficient evidence to overcome a *Caremark* claim at this stage. Even the minutes' documentation of the Blue Bell board being informed of the success of a third-party's sanitation audit failed to carry much weight with the Supreme Court. In recent cases dismissing *Caremark* claims, however, more detailed board minutes have played a central role in the claims' dismissal.[16]

Finally, it may be advisable to supplement long-form minutes with presentations and other materials in connection with regulatory or other updates provided to the board.[17] As such board materials are prepared contemporaneously, they may provide particularly strong evidence of the board's satisfaction of its duty of oversight.

Notes

1. Marchand v. Barnhill, — A.3d —, 2019 WL 2509617, at *2 (Del. June 18, 2019).
2. *Id.* at *2.
3. *Id.* at *8.
4. *See* In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).
5. Marchand v. Barnhill, 2018 WL 4657159 (Del. Ch. Sept. 27, 2018), *rev'd*, 2019 WL 2509617.
6. For *Caremark* claims, demand futility is generally analyzed under the *Rales* test, which traditionally examines whether a majority of the directors would have been disinterested and independent in considering any derivative demand. *See* Rales v. Blasband, 634 A.2d 927 (Del. 1993). Blue Bell's certificate of incorporation entitled the director appointed by its new private equity investor to one-third of the voting power of its board—*i.e.*, 5 of the 15 votes entitled to be cast by its 11 person board. Accordingly, both the Court of Chancery and the Supreme Court looked to whether the directors holding a majority in voting power of Blue Bell's board were disinterested and independent, not whether a majority of its directors were disinterested and independent.
7. *See, e.g.*, Del. Cnty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1022 (Del. 2015) (finding that a director was not independent of another director due to their 50 year friendship because "[c]lose friendships of that duration are likely considered precious by many people, and are rare . . . . and when a close relationship endures for that long, a pleading stage inference arises that it is important to the parties"); Sandys v. Pincus, 152 A.3d 124, 131 (Del. 2016) (holding that co-ownership of an airplane "is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment"); *see also* John Mark Zeberkiewicz & Stephanie Norman, "Delaware Supreme Court Revisits Director Independence in Considering Derivative Demands," 31 *Insights* 1 (Feb. 2017).
8. *Marchand*, 2019 WL 2509617, at *10 (*quoting* In re Oracle Corp. Deriv. Litig., 824 A.2d 917, 938 (Del. Ch. 2003)).
9. *Id.*
10. *Id.* at *11.
11. *Id.* at *12.
12. *Id.* at *14.
13. *Id.* at *15.
14. *Id.*
15. This may have added significance as more public Delaware corporations adopt complex governance or control structures. In the event that control over a corporation is to be exercised at the board level by a director with extraordinary voting power, it may be advisable to include a carve-out reverting to one vote per director for board decisions relating to derivative demands in order to decrease the likelihood that such disproportionate voting power could render demand futile.
16. *See, e.g.*, City of Birmingham Ret. & Relief Sys. v. Good, 177 A.3d 59, 62–64 (Del. 2017) (dismissing *Caremark* claims where board minutes and materials showed that the board had knowledge of and attempted to remedy regulatory issues, not that the board had longstanding knowledge of such issues and intentionally disregarded them); Ok. Firefighters Pension & Ret. Sys. v. Corbat, 2017 WL 6452240, at *17 (Del. Ch. Dec. 18, 2017) ("The [] board met on December 12, 2012, and at that meeting, the directors were informed of 'proactive efforts

concerning [anti-money laundering] issues, [and] that management's current areas of focus include the Consumer North America high risk account re-remediation; expired customer due diligence documentation; migration programs in Mexico; . . . and broader structural issues.' And the directors learned of 'continued progress on OCC commitments and business priorities, including creating and implementing a global governance structure and framework and short-term tactical project execution.' These are not the minutes of a board that learned of red flags suggesting corporate misconduct and chose to do nothing about them. Instead, they reflect that steps were taken to improve the systems and controls related to [anti-money laundering] compliance.").

17. *See, e.g.*, *City of Birmingham*, 177 A.3d at 59 ("The presentations identified issues with the coal ash disposal ponds, but also informed the board of the actions taken to address the regulatory concerns. Thus, we agree with the Vice Chancellor that the board presentations do not lead to the inference that the board consciously disregarded its oversight responsibility by ignoring environmental concerns.").