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Delaware Supreme Court Reverses Dismissal of a Fiduciary "Caremark" *Suit After Finding the Board Did Nothing to Assure Board-Level Oversight of Regulatory Compliance—* Marchand v. Barnhill ("Blue Bell")

In *Marchand v. Barnhill* ("*Blue Bell*") (June 18, 2019), the plaintiff-stockholder claimed that the directors of Blue Bell Creameries USA, Inc., an ice cream manufacturer (the "Company"), breached their fiduciary duty of loyalty under *Caremark* by having failed to oversee and monitor the Company's food safety operations. The suit was brought after an outbreak of listeria contamination in the Company's ice cream led to the sickening and (in three cases) the death of consumers who ate the ice cream--as well as the recall of all of the Company's products, the shuttering of all of the Company's plants, and, ultimately, a liquidity crisis that led the Company to accept a dilutive private equity deal.

"*Caremark* claims" are claims that directors breached the fiduciary duty of loyalty by not making "a good faith effort to oversee the company's operations." These claims, which if successful can result in personal liability for directors, are known to be (as the Supreme Court reiterated in *Blue Bell*) "among the most difficult of corporate claims" to pursue successfully--because a required element of a claim for breach of the duty of loyalty is "bad faith" (*i.e.*, *intentional* wrongdoing) by directors. *Caremark* established that, with respect to a board's oversight obligation, only a "sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to [personal] liability [of directors]."

In the decision below, the Court of Chancery had dismissed the suit on the basis that the Company's food safety operations were subject to a reasonable system of oversight through the extensive regulatory scheme to which the Company was subject (which included inspections and reports by federal and state regulators). The Supreme Court overturned the dismissal, however, after finding that the facts alleged in the complaint indicated that *the board itself* had taken no action to assure a system for *board* oversight of food safety.

Blue Bell thus serves as a reminder that, while *Caremark* claims are difficult to plead successfully, there *are* circumstances under which these claims may prevail (particularly at the pleading stage, during which the court must draw all reasonable inferences in favor of the plaintiff). Notably, in *Blue Bell*, the factual context was egregious in terms of both the board's inattentiveness (for example, the board minutes reflected that the board never discussed anything about food safety, even in the midst of the unfolding listeria crisis) and the dire consequences thereof (*i.e.*, the deaths of consumers of the ice cream).

Key Points

- **It continues to be difficult to prevail on a *Caremark* claim.** The Supreme Court reiterated in *Blue Bell* the high standard for validly pleading a *Caremark* claim--as noted, that a board "utterly failed" to put into place "any" monitoring system for oversight. The Supreme Court acknowledged that the validity of a *Caremark* claim does not depend on whether a board's oversight system actually worked in any given case to inform the board as to compliance matters, but only whether a reasonable system *existed* and was monitored by the board. In this case, the Supreme Court found that the complaint alleged specific facts that, at the pleading stage, created a reasonable inference that the directors had "consciously failed" to attempt to assure that a reasonable information and reporting system existed with respect to the Company's "central issue" of food safety compliance.

- **The Supreme Court emphasized that there was no system in place for *board-level* oversight of food safety--the "central" issue for an ice cream manufacturer.** The Supreme Court concluded that neither the fact that the Company was subject to a food safety regulatory scheme, nor the fact that management regularly reported to the board generally on "operations," defeated the *Caremark* claim. The Supreme Court's focus was on the "dearth" of "board-level" oversight. Although the "central compliance issue" for the Company was food safety, the board had "no committee overseeing food safety, no full board-level process to address food safety issues, and no protocol by which the board was expected to be advised on food safety reports and developments."

- **The Supreme Court emphasized that management, although it was aware of serious safety issues, did not report them to the board.** In *Blue Bell*, although the regulators had identified and communicated to management about serious violations, the management never reported anything about them to the board (until after the Company's products had to be recalled). The board minutes reflected that the board never discussed food safety issues at all until management apprised it of the products recall, and even thereafter the board did not discuss or oversee management's operational response. The Supreme Court viewed as part of the evidence that the board had not established a reasonable information and reporting system the fact that no information was reported to the board.

- **The decision thus underscores the critical importance of the board assuring a system of oversight *by the board itself* of the company's key operations**--particularly with respect safety issues involved in the manufacture of its products. An oversight system should include both (i) *management* reporting to the board about risks and developments relating to the company's central operations and (ii) the *board* proactively seeking out this information from management.

Background

Blue Bell, one of the largest ice cream manufacturers in the U.S., was subject to food safety regulation by the FDA and the three states in which it operated plants. From 2009-2013, several regulators found troubling compliance failures at Blue Bell's plants relating to sanitation. In 2013 and 2014, lab testing of swabs from the Company's plants was positive numerous times for listeria and other contamination. In 2015, the listeria contamination spread to the Company's products (its ice cream) and "spiraled out of control." The Company initiated a limited recall of products in February 2015. According to the plaintiff's complaint, as corroborated by the Company's board minutes, management did not inform the board about any of these problems until after the recall. At that time, the board expressed that it was leaving to management the Company's response to these problems. In early March 2015, health authorities linked human infections to the Company's ice cream and the Company was forced to recall more products. The board then met and adopted a resolution expressing "support" for the Company's management and "encouraging" them to ensure that the Company's products are "wholesome and good testing [sic]." Within a month later, the Company was forced to institute a recall of all of its products. By this time, the Center for Disease Controls and Prevention (CDC) had linked a human listeria outbreak--which involved eight people sickened in two states, three of whom died--to two of the Company's three plants.

After the full recall, an FDA inspection revealed "major deficiencies" at each of the Company's plants (including, for example, failure to heat water to the temperature needed to sanitize equipment and failure to store food in clean equipment). The FDA observed that most of the problems had been present and known to management since well before the listeria outbreak. News reports followed in which former employees stated that management had ignored complaints about plant conditions and had regularly permitted dangerous conditions (such as leaving ice cream to pool on the floor, which created an environment where bacteria could easily grow, and pouring ice cream and fruit that had dripped off the machines into mix to be used later). With its operations shuttered, the Company faced a liquidity crisis and entered into a dilutive private equity deal.

The plaintiff-stockholder obtained books and records (including the board's minutes) through a Section 220 request and then brought suit in the Court of Chancery against the directors, the CEO and the Vice President of Operations. Vice Chancellor Slights ruled, first, that demand on the board to bring a derivative action was not excused because the complaint plead facts that indicated that only 7 of 15 directors (*i.e.*, not a majority) were incapable of impartiality on the question whether to sue the CEO. Second, the Vice Chancellor ruled that the *Caremark* claim was not valid. He concluded that, although in this case the Company's contamination problem was not detected by the board, a reasonable oversight system was in place (through the regulatory scheme) and it was monitored by the board (through regular reports by management on operations generally)--and these, rather than the system's effectiveness, were the relevant considerations under *Caremark*. The Supreme Court, in an opinion written by Chief Justice Strine, overruled both of these rulings and remanded the case for further proceedings.

Discussion

The *Caremark* doctrine. In *Caremark* (1996), the Court of Chancery discussed in detail the parameters of a board's duty of oversight. Personal liability for directors with respect to their oversight function may "arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." Accordingly, to fulfill their duty of loyalty (as confirmed in *Blue Bell*), "directors must make a good faith effort to implement an oversight system and then monitor it." At the same time, *Caremark* established that only a "sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to [personal] liability [of directors]." *Caremark* also established that the sufficiency of the systems established by the board would be evaluated under the deferential business judgment rule. Thus, *Caremark* claims have been recognized by the Delaware courts as "among the most difficult of corporate claims" to pursue successfully. Decisions amplifying *Caremar*k have emphasized the following:

- *Bad Faith.* A showing of "bad faith" is a necessary condition to director oversight liability, as Section 102(b)(7) of the Delaware General Corporation Law contemplates personal liability of directors only for breaches of the duty of loyalty, including acting in "bad faith." In the *Caremark* context, "bad faith" encompasses "scienter," "intentional wrongdoing" or "intent to harm," and would be established by "intentional dereliction of duty" or "complete and utter failure to act in the face of a known duty to act."

- *Particularized Facts.* The complaint must plead particularized facts showing that oversight systems were not in place (rather than a "conclusory complaint" that there was not oversight).
- *"Red Flags."* The existence of "red flags" that should have alerted management and the board to compliance problems will not alone indicate "bad faith" without "particular allegations as to how the defendants knew of…inadequacies [in the oversight systems] and consciously ignored them."

In *Blue Bell*, the Supreme Court acknowledged that "*Caremark* is a tough standard for plaintiffs to meet" but found that "the plaintiff has met it here." The Supreme Court stated: "When a plaintiff can plead an inference 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, then that supports an inference that the board has not made the good faith effort that *Caremark* requires." Bad faith is established under *Caremark*, the Supreme Court wrote, when "the directors *completely fail* to implement any reporting or information system or controls, or having implemented such a system or controls, *consciously fail* to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention" (emphasis added). The critical issue, the Supreme Court acknowledged, is not whether "illegal or harmful company activities escaped detection [of the board]" (*i.e.*, not whether the board put into place an *effective* compliance and reporting system) but whether the board "failed to make the required good faith effort to put a reasonable compliance reporting and compliance system in place [and monitor it]." The important "bottom-line requirement" of *Caremark* is that "the board must make a good faith effort--*i.e.*, *try*--to put in place a reasonable board-level system of monitoring and reporting" and then monitor it.

According to the Supreme Court, the Court of Chancery had viewed the plaintiff's complaint as supporting a reasonable inference that the board had not established an *effective* board-level compliance and reporting system--but not as indicating that the board had not tried to establish *any* system. The Supreme Court emphasized that it viewed the plaintiff's complaint not as a challenge to the effectiveness of an oversight system but as indicating that no board-level oversight system *existed*. Specifically, before the contamination problem "engulfed" the Company, allegedly:

- no board committee existed that addressed food safety issues;
- no "regular processes or protocols" existed that required management to keep the board apprised of food safety compliance practices, risks or reports;
- no "schedule" existed for the board "to consider on a regular basis" whether food safety risks existed;
- during the period leading up to the deaths of the Company's customers, "managers received reports that could be considered red, or at least yellow, flags [specifically, reports and complaints from regulators], and the board minutes of the relevant period revealed no evidence that these were disclosed to the board;
- management told the board about a favorable food safety inspection report, but did not give "important reports that presented a much different picture"; and

- “the board meetings [were] devoid of any suggestion that there was any regular discussion of food safety issues.”

The Supreme Court rejected the defendants’ argument that the *Caremark* liability standard was not met because “by law Blue Bell had to meet FDA and state regulatory requirements for food safety,” that the government regularly inspected Blue Bell’s facilities with management receiving the results, or that the Company had in place employee manuals relating to food safety. These factors did not indicate that “*the board* implemented a system to monitor food safety *at the board level*,” the Supreme Court wrote (emphasis in original). “The mundane reality that Blue Bell is in a highly regulated industry and complied with some of the applicable regulations does 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.”

The Supreme Court rejected the Chancery Court’s finding with respect to one director that he could not be impartial with respect to whether to bring suit against the CEO. The Court of Chancery had found that demand on the board to bring suit would not have been futile and therefore was not excused. The Court of Chancery had concluded that a majority of the board votes were held by directors who could not be impartial due to their “close and thick” relationships with the CEO and the CEO’s family to whom they owed deep gratitude for the opportunities provided to them which led to their successful careers. The Supreme Court disagreed with respect to one director. The Court of Chancery had viewed this director as capable of impartiality because, although he too had the described close relationship with the CEO and otherwise would have been considered not capable of impartiality, his impartiality had been demonstrated by his recently having voted differently from the CEO when the board had considered the issue of separation of the CEO and Chair roles. The Supreme Court disagreed. In its view, the Court of Chancery had “ignored that the decision whether to sue someone is materially different from and more important than the decision whether to part company with that person on a vote about corporate governance.” (The opinion did not address the fact that this particular “governance issue” directly related to the CEO’s own interest in continuing as the Chair.) The Supreme Court emphasized that, at the pleading stage, the plaintiff is to be accorded the benefit of all reasonable inferences, and observed that the director “owe[d] an important debt of gratitude and friendship to the [CEO’s] family for giving him his first job, nurturing his progress from an entry level position to a top manager and director, and honoring him by spearheading a campaign to name a building at an important community institution after him.”

Practice Points

- **Need to establish board-level oversight.** A board should establish a reasonable system for its oversight of the Company’s operations, particularly with respect to compliance with legal and regulatory obligations. The system should include processes and protocols for reporting to the board and monitoring by the board, with emphasis on those issues that are “central” to the company’s business (such as food safety regulations for a food manufacturing company). Even when a company is subject to oversight by regulators, the company utilizes employee manuals that provide guidance for regulatory compliance, and the board receives reports from management as to the company’s operations *generally*, the board should establish *board-level* systems for oversight and monitoring of the issues central to the company’s operations.

- **Critical need for reporting to the board.** The audit committee, the outside auditors, and management should keep the board focused on, and apprised of key developments with respect to, issues and risks that are central to the business. A complete picture should be presented (rather than cherry-picking favorable information and not reporting negative information). When management learns of "yellow flags" or "red flags" (such as complaints or reports from regulators) relating to noncompliance with regulations or other matters "central" to the company's operations, management should inform the board. In *Blue Bell*, the lack of reporting of negative information from management was viewed by the Supreme Court as itself evidence that the *Caremark* standard of reasonable reporting systems being in place was not met.

- **A board should consider establishing and maintaining:**
  - one or more board committees to oversee and address the company's compliance with and risks related to the regulations, and other matters, central to its business;
  - regular processes and protocols requiring management to keep the board apprised of key compliance and other practices, risks or reports; and
  - a schedule for the board to consider on a regular basis whether compliance (or other) risks exist and steps taken to contain them.
- **Board minutes should reflect the board's monitoring and oversight efforts.** Board minutes should reflect the board's efforts to establish, implement and maintain oversight systems; the board's regular discussion of key compliance and other issues; and management's disclosure to the board of compliance and other key risks and developments.
- **Continued prevalence of Section 220 requests.** The decision is another reminder of the increased prevalence of Section 220 books and records requests and the courts' looking favorably on plaintiffs who pursue the receipt of books and records prior to commencing litigation.
- **Possibly heightened risk under *Caremark* where human life or health is involved.** *Blue Bell* may reflect that the court will be more likely to find a *Caremark* violation when the board's oversight failures relate to human health and safety and/or resulted in deaths or serious health issues. Thus, directors of companies in businesses such as pharmaceuticals, medical devices, transportation, and the like, may face a heightened risk of *Caremark* liability as compared to directors of other companies.
- **Heightened risk under *Caremark* relating to compliance with positive law.** In another recent decision (*Facebook Section 220 Litigation*, May 30, 2019), Vice Chancellor Slights underscored that the court is more likely to find a *Caremark* violation in cases where a board failed to oversee "the company's obligation to comply with positive law, or positive regulatory mandates…than …to oversee the company's efforts generally to avoid business risk." In *Facebook*, the Vice Chancellor viewed the Facebook board as having had a heightened oversight obligation with respect to maintaining the privacy of its customers' personal data because the company had "a positive obligation" under a consent decree with regulators to implement certain data privacy protections.
- **A director's voting differently from another director on a governance matter may not establish the director's impartiality with respect to the issue of demand futility.** As discussed, in *Blue Bell*, the Supreme Court viewed the decision whether to sue a person as "materially different and more difficult" than a decision to "part ways on a governance matter."

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